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Taxation

Report Vol. 2

1966

REPORT

OF THE

ROYAL COMMISSION ON

TAXATION

VOLUME 4

TAXATION OF INCOME (continued)

Part B - Taxation of Income Flowing Through Intermediaries
Part C - Determination of Business Income
Part D - International

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CANADA

REPORT

of the

ROYAL COMMISSION ON TAXATION

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PART B

TAXATION OF INCOME FLOWING THROUGH INTERMEDIARIES

CHAPTER 19

CORPORATIONS

Canada has levied a tax on corporate income since 1917. Although this tax has been productive of substantial revenue and has been relatively easy to administer, it does not necessarily follow that it is an efficient and equitable tax. In order to judge the efficiency and equity of the levy, it is first necessary to examine the incidence of the tax.

Because income tax is collected from corporations, trusts, and co-operatives, it does not mean that these organizations bear the burden of the tax. Ultimately, the burden of the tax on the organization is the relative reduction in the power of people to consume. This reduction can take the form of reduced payments to people who sell goods and services to the organization, increased prices for those who buy goods and services from the organization, reduced incomes to those who hold interests in the organization or reduced sale prices received for these interests by those who dispose of them. We recognize that it has been extremely useful to treat corporations as persons "in contemplation of law", and we agree that the shareholders of a large, widely held corporation usually do not have a major voice in the decisions of the corporation. But the rights and obligations of the corporation or the decision-making powers of those who control the corporation are irrelevant considerations from the viewpoint of deciding who bears the corporation income tax. The fact that an individual shareholder or a manager may be able to make the major decisions of the corporation does not mean that he bears any particular proportion of the burden of the tax on the corporation. His power to consume goods and services for personal use may be completely unaffected by the corporation income tax.

Taxing the income of organizations is an inexpensive method of collecting taxes, but unless the tax is integrated with the taxation of the incomes of the individuals or families who hold interests in these organizations, the

tax system cannot be either equitable or neutral. When the income of organizations is taxed differently from other kinds of income, and the income of different kinds of organization is not taxed in a similar manner, avenues for tax minimization are created that are more readily available to some individuals than to others. As we explain later, to the extent that such taxes are not avoided they may be quickly shifted on to consumers and suppliers through prices and cost changes and thus become crude sales and cost-factor taxes. When these taxes on organizations are neither avoided nor shifted in this sense, they become capricious taxes on some kinds of wealth at the time they are imposed. Unless they are completely avoided, they distort the allocation of resources and reduce the value of our national output.

Equity and neutrality would best be achieved under a tax system in which there were no taxes on organizations as such, and all individuals and families holding interests in organizations were taxed on the accrued net gains from such interests on the same basis as all other net gains. Under such a system, shareholders of corporate organizations would be required to bring the following into their annual tax bases:

1. Dividends received during the year.

2. The gains or losses on shares disposed of during the year, that is, realized gains and losses.

3. The change in the value of the shares held over the year end, that is, accrued gains and losses.

The net gains from holding interests in other organizations would be treated in the same way.

Although we can see no grounds in principle for taxing corporations and other organizations, we have reluctantly reached the conclusion that there are good and sufficient reasons for continuing to collect a tax from them.

The main reason is the practical difficulty of taxing accrued share gains as required under the ideal approach we have just described. Another reason is the loss in economic benefit to Canada that would result if non-residents holding shares in Canadian corporations were not taxed by Canada on their share of corporate income at approximately the rates that now prevail.

Valuation problems preclude the annual taxation of share gains on an accrual basis, while to tax shareholders only on dividends received and gains realized without any tax on corporations, would permit massive and unwarranted postponement of personal income tax. In the absence of a tax on the undistributed earnings of corporations, those individuals who could arrange to receive income through corporations could retain their savings untaxed in the corporation. These untaxed savings would earn a return that would also escape taxation if the return was also retained and reinvested by the corporation. The result would be an inordinate tax advantage to those who could channel income through a corporation. Even if all of the shareholders of Canadian corporations were residents, it would still be essential to tax at the top personal rate that part of the current income of corporations that was not included in the tax bases of shareholders, in order to preclude tax postponement.

A substantial proportion of the shares of Canadian corporations is held by non-residents. As we emphasize in Chapter 5, the revenues derived from taxing the corporate source income attributable to non-residents provide a major economic benefit to Canada. If Canada did not tax corporate income on an annual basis at a rate roughly equal to the rate other countries impose on the foreign corporate income generated by their residents, we would simply be transferring substantial revenue from the Canadian treasury to foreign treasuries with little reduction in taxes to the non-resident shareholder. This would provide a substantial windfall benefit to foreign governments at Canada's expense, for foreign governments would be most

unlikely to reciprocate. Imposing a high withholding tax on dividends paid to non-residents would not provide an adequate substitute for a corporation income tax. If this course was followed, non-residents could retain all of the income free of tax in a Canadian corporation and could then realize their gains by selling their shares. Such gains could not, as a practical matter, be taxed by the Canadian government. In any event, the existing tax treaties preclude an increase in the Canadian withholding tax to compensate for the reduction in corporation tax. If the treaties were amended to permit such an increase, foreign governments would probably retaliate by raising their withholding taxes on the foreign source income of Canadian residents. The importance of the Canadian corporation income tax revenue from foreign investment in Canada, and the need to avoid the foreign retaliation that would probably follow if Canada raised its withholding tax, dictate that corporate income should continue to be taxed at the corporate level at a rate of approximately 50 per cent.

After an exhaustive examination of the alternative methods of taxing corporate income, we have come to the conclusion that the method we recommend for the full integration of personal and corporation income taxes is without doubt the best system. It would achieve the greatest equity and neutrality consistent with the inescapable facts that accrued share gains cannot be brought initially into income each year and that Canada should tax the Canadian corporate income of non-residents at a rate of about 50 per cent.

The full-integration system is not an original idea 1/. What are original are our solutions to the practical problems that were thought to preclude the adoption of this method of taxing corporate source income. The following are the basic features of the full-integration system we recommend:

1. The income of Canadian corporations should be subject to a flat rate of tax of approximately 50 per cent.

2. Individuals and families should be subject to progressive rates of tax with a top marginal rate of 50 per cent.

3. The tax base of the resident shareholder should include the corporate income paid or allocated to him, "grossed-up" for the corporation tax paid 2/.

4. The resident shareholder should receive credit against his personal income tax liabilities for the full amount of the corporation tax paid in respect of the after-tax corporate income paid or allocated to him, with a refund if the credit exceeded the liability.

5. Realized gains or losses on corporate shares should be included in income and taxed at full progressive rates.

6. The corporation should be allowed to allocate after-tax corporate income to shareholders without having to pay cash dividends.

7. The cost basis of shares should be increased when the corporation allocated retained corporate earnings to shareholders, so that share gains resulting from the retention of earnings that had been taxed to the shareholder would not be taxed again to the shareholder when realized.

Under the system we propose, the receipt by a resident shareholder of a $50 cash dividend from a corporation which had been taxed at 50 per cent would be treated as shown in Table 19-1 which follows. As this table illustrates, each shareholder would ultimately pay only his personal tax on an original income of $100 at the corporate level.

TABLE 19-1

ILLUSTRATION OF THE
FULL-INTEGRATION SYSTEM

		Tax Bracket of the Shareholder		
		15 per cent	35 per cent	50 per cent
1.	Income (grossed-up dividend)	$100	$100	$100
2.	Personal tax	$ 15	$ 35	$ 50
3.	Minus: tax already paid by corporation	($50)	($50)	($50)
4.	Tax (refund)	($35)	($15)	(-)
5.	Plus: cash dividend	$ 50	$ 50	$ 50
6.	Total cash received by the shareholder	$ 85	$ 65	$ 50

The system of full integration that we propose has some features similar to those of the system recently abolished by the United Kingdom. There are, however, a number of crucial differences that are described later. In our opinion, these differences correct the principal defects in the previous United Kingdom system without losing its advantages.

We have already described the general equity and neutrality advantages of the full-integration system; we also draw attention to the following specific advantages it possesses:

1. The tax system would neither encourage nor discourage the retention of earnings by corporations, because the shareholder would be entitled to the same tax credit on an allocation by the corporation of its income as on the payment of a dividend.

2. Corporate cash retentions could be increased without worsening the cash position of most shareholders.

3. Corporations raising capital in Canada would be less affected by tax considerations in the choice between debt and equity financing.

4. To the extent that the reduction in the tax on corporate source income was not passed on in the form of lower prices or higher costs, the after-tax income from Canadian equities would be increased to most Canadians with the result that share prices would rise, the cost of equity capital would fall and the rate of capital formation by corporations would increase.

5. The increase in Canadian share prices should encourage non-residents holding shares in Canadian corporations to sell them to Canadians, and Canadian corporations wholly owned by non-residents would be encouraged to raise capital by issuing equities in Canada.

6. The advantages of, and facility for, tax avoidance by means of "surplus-stripping" that are inherent in the present tax structure would be removed.

7. Tax avoidance through the creation of associated companies to take advantage of the dual rate would be eliminated.

8. The tax treatment of corporations, trusts and mutual organizations would be put on substantially the same basis.

9. The allocation of resources would be improved with a resulting increase in the output of the goods and services that Canadians want.

10. All corporate source income (other than the income accruing for non-resident shareholders) would be taxed at the progressive rates applicable to the individual shareholder.

The balance of this chapter is devoted to a description of the present system, an appraisal of its defects, a review of alternative ways of overcoming these defects, a fuller exploration of the proposals we recommend and a consideration of transitional and other problems.

THE PRESENT SYSTEM

General

In very general terms, corporate source income in Canada is taxed in the following ways:

1. The corporation is taxed on its income computed in accordance with the ordinary rules for determining business or property income. It pays dividends out of after-tax income.

2. Corporations receiving dividends from other taxable Canadian corporations or from certain foreign companies may, with specified limitations, exclude such dividends from taxable income.

3. The individual resident shareholder includes dividends in income and is allowed a credit against his total tax liability equal to 20 per cent of the dividends paid to him by taxable resident corporations.

4. The individual shareholder ordinarily does not include in income gains on shares nor does he deduct losses on shares.

5. Dividends paid to non-residents are subject to a withholding tax at rates of either 10 per cent or 15 per cent (in specified circumstances).

Thus, the corporate flow of income is taxed at two levels and at two different times. The corporation tax is levied when the income is earned, and the shareholder is taxed when he receives a distribution from the corporation. The second event, if it occurs at all, may occur many years after the income is earned at the corporate level. Most of the problems in this area have arisen because the shareholder can delay the imposition of the second tax, and perhaps even arrange his affairs so that he need not pay it at all. We will describe some of these procedures and then will indicate how our proposals would eliminate these problems.

At present, the combined federal and provincial taxes on corporate income range from 21 per cent to 23 per cent on the first $35,000 of taxable income, and from 50 per cent to 52 per cent on the excess, the exact rates depending on the province involved 3/.

Current Distributions

Initially, dividends paid by Canadian companies were treated in a manner similar to that which was until recently followed in the United Kingdom, whereby a "normal" tax paid by the corporation entitled the dividend to be free of "normal" tax in the hands of the individual shareholder, although he might be liable to additional tax. In 1926 this concept changed, the corporation being thereafter regarded as a separate entity for tax purposes and the dividends becoming fully taxable to the shareholders. Dividends between resident companies were made exempt from tax.

The complete separation of corporate and personal taxation was modified in 1949 when resident shareholders became entitled to a tax credit of 10 per cent of dividends received from taxable Canadian corporations. The announced purpose of this change was to relieve the double taxation of corporate income, to provide some incentive for Canadians to invest in Canadian companies and to encourage equity rather than debt financing. In 1953 the dividend tax credit was increased to 20 per cent. These changes in the rate of tax credit corresponded closely to changes in the lower rate of corporation tax and provided almost complete relief for the corporation tax paid by corporations with small incomes.

Retained Earnings

With a dividend tax credit of 20 per cent and a top personal tax rate of 80 per cent, the additional tax to be paid on dividend distributions could be as high as 60 per cent. This taxation of dividend distributions has encouraged retentions by corporations 4/. Shareholders have enjoyed a considerable tax deferment advantage on these retentions, and some have also

been able to realize the retentions free of tax through sales of shares. The accumulation of undistributed income led to a "bunching" of income when distribution finally occurred, and relief was sought by taxpayers from the attendant high rates of personal income tax. Some relief measures were provided by specific legislation, others by the ingenuity of taxpayers in the form of surplus-stripping.

The first legislative relief from the tax liability on accumulated income of corporations was for the years 1930-34, when free distribution was permitted of the income accumulated prior to 1930. The next step followed the proposals of the Ives Commission in 1945 and permitted the income accumulated in certain private companies up to 1939 to be distributed upon payment of a tax of between 15 per cent and 33 per cent, depending upon the amount of the distribution to each shareholder. In 1950, additional relief was introduced under which accumulated surplus at 1949 held by any company could be cleared of any further tax liability on the payment by the corporation of a 15 per cent tax. An amount of post-1949 surplus equal to dividends paid after 1949 could also be cleared of further tax liability by payment of a special tax at the same rate.

These measures provided substantial relief for the upper income shareholders of closely held corporations, and many such taxpayers took advantage of these relieving provisions shortly after they were introduced. However, these taxpayers and their advisers soon developed surplus-stripping techniques by which the retained earnings of closely held corporations could be distributed with the payment of even less, if any, personal tax.

Surplus-Stripping 5/

The term surplus-stripping is usually applied to situations where there is an actual distribution of accumulated corporate income and tax thereon is avoided by legal but artificial means. In the original version the shareholder realized on the accumulated income by a tax-free sale of shares,

while the actual distribution went tax free to another corporation set up for the purpose and could be applied by it toward the purchase price of the shares. To block this device the government introduced the "designated surplus" provision, which provided that where control of one resident corporation was acquired by another, a dividend out of surplus existing when control changed, that is, designated surplus, would not qualify for the usual exemption from tax for intercorporate dividends 6/.

Other surplus-stripping procedures involved diversion of the distribution to parties which could receive distributions without substantial tax liability, such as an organization specifically exempt from tax, a non-resident corporation which could receive a distribution subject only to any applicable withholding tax, or to a dealer in securities which could offset dividend income by a loss on disposition of the shares. The legislative response to these practices came in 1955 and, in effect, gave them sanction by imposing a tax on them of 15 per cent or 20 per cent depending on the circumstances 7/. Further possibilities for stripping surplus free of tax emerged in the special rules for statutory amalgamations, and in 1959 a new section was introduced 8/ providing for a tax of 20 per cent on the portion of the undistributed income of the merging corporations that was no longer represented by assets of the continuing entity. This loophole never was successfully closed; even after subsequent amendments it continued to offer means of avoidance.

Over the years many more complex variations of surplus-stripping have been devised, all directed toward the extraction of undistributed income from a corporation without payment of substantial further tax. Many of these depend on the avenue of the intercorporate tax-free dividend, and nearly all would be discouraged by the taxation of share gains.

During the course of these complex and frustrating developments, the general anti-avoidance provisions of the legislation were not tested before the courts, nor was any attempt made to add to the law some basic guiding principle such as the United States "business purpose test". Rather,

various attempts were made to control the techniques by specific legislation aimed at specific types of transactions. Experience has shown, however, that taxpayers and their advisers have been able to thwart such attempts by developing procedures falling outside the circumstances specified in the legislation.

In 1963 the government in effect admitted the lack of success of its specific measures and resorted to a general and arbitrary measure to deal with the problem when it enacted section 138A(1). Briefly, this provision permits the Minister to levy tax on certain amounts received by shareholders as a result of transactions which, in the opinion of the Minister, had as one of their purposes a substantial reduction or disappearance of the assets of the corporation in such a way as to avoid the tax that would otherwise have been payable on a distribution. A limited appeal is provided from the assessment made by the Minister. Although it appears that this was not intended as a permanent solution it has been effective. However, considerable dissatisfaction has been expressed by taxpayers with the uncertainty involved and with the impact on some ordinary business transactions.

Recently the Department has undertaken to attack many surplus-stripping transactions which were effected before the enactment of section 138A(1). At the time of writing it remains to be seen how much success this programme will have.

The realization of undistributed income by the types of technique described above has involved an actual distribution of retained earnings. What is not commonly appreciated, however, is that the advantages of tax deferment on retained earnings are such that a very substantial saving can be obtained without any distribution taking place. Where income is retained indefinitely the postponement of the tax due upon its eventual distribution is as good as a substantial tax reduction. With an interest assumption of 6 per cent, the present value of one dollar 25 years hence is 23 cents, of one dollar 50 years hence, 5 cents. Postponement of taxes for 25 years is thus equivalent to a 77 per cent tax reduction.

Furthermore, a shareholder in a public corporation can realize upon his share of the retained earnings by a tax-free sale of shares, thus effectively "stripping" his interest in the undistributed income without any distribution. In a closely held corporation, where the shareholders are more likely to be faced with an ultimate distribution of surplus, such indefinite postponement is not so readily available. In a real sense, surplus-stripping simply gave shareholders in closely held corporations the same advantage as was enjoyed by shareholders in those widely held corporations that retained a large part of their earnings. Both were able to avoid personal tax by the sale or liquidation of shares at prices unaffected by taxation.

Corporate Acquisitions and Reorganizations

Under the present system, tax considerations can be very material if one corporation wishes to acquire control of another. The applicable considerations and their relative importance will vary from case to case, but one or two general observations may illustrate the problem. From the point of view of the acquiring corporation, the acquisition of the controlling shares of the other corporation may lead to the creation of designated surplus in the latter corporation, while a purchase of assets will avoid this and may permit the taking of higher capital cost allowances on depreciable assets than would have been available to the vendor corporation. Moreover, interest paid on money borrowed to purchase shares is not deductible for tax purposes by an acquiring corporation (because dividends received on the shares would be exempt income), whereas interest paid on money borrowed to purchase assets is deductible. Thus, there will often be a distinct advantage to an acquiring corporation in purchasing assets rather than shares. From the point of view of the selling shareholders a sale of shares may lead to the realization of a tax-free gain; but a sale of assets of the company at a profit may lead to some corporation income tax, for example, on the recapture of depreciation and, if it leads to a winding-up of the company, could result

in a further tax on the shareholders because of the distribution of any undistributed income which is deemed to occur on the winding-up. The controlling shareholders of a company may frequently, therefore, prefer to sell shares rather than assets.

The present system has also had an inhibiting effect on certain types of corporate reorganization. If a corporation, at a time when it has undistributed income, takes certain steps such as the redemption of common shares, the reduction of its common share capital, the conversion of common shares into preference shares or obligations, or the capitalization of undistributed income, the shareholders are deemed by section 81 of the Act to have received dividends out of undistributed income, and this has the usual consequences for the shareholders. When substantial undistributed income has been accumulated it may not be considered expedient to take steps of the nature indicated because of the tax impact on the shareholders.

Personal Corporations

In essence, a personal corporation is a corporation used by individual taxpayers to hold their investments. Through this device they bring their assets together in one corporation for better management and convenience, not only during their lifetimes but also to facilitate management of their estates. However, this arrangement also has an ancillary advantage. Because intercorporate dividends are not taxed, an investor could accumulate his dividend income in a corporation without the payment of any personal tax until the corporation in turn distributed the income to him. In an attempt to prevent this deferment of personal tax on dividends, while not precluding the use of such a corporation for good business or personal reasons, the legislation introduced the concept of a "personal corporation" 9/. Companies falling within the definition are not subject to corporation tax on their income, but the shareholders pay tax as though the income was all distributed in the year received in the manner set out in the legislation. A company is a personal corporation if at least 25 per cent of its income is from

investments, if control is held by or for a resident individual alone or with resident members of his family as defined and if no active business is carried on. However, the status of a personal corporation can easily be avoided by introducing some element of business activity or by exploiting weaknesses in the definition of control by an individual and members of his family.

Personal corporations have become increasingly popular for estate-planning and income-splitting purposes. Extensive amendments to the Act were introduced in 1961 in an attempt to correct some of the abuses, but were withdrawn following strong protests, the principal objection being that changes should await a general revision of the taxation of corporate distributions.

Investment Companies

The separate taxation of the corporation has also created problems for corporations which pool investment funds of the public at large and act as conduits between the source of the income and the investor.

Under the ordinary rules for taxation of corporate income and corporate distributions, some of the investment income, such as interest and foreign dividends flowing through such corporations, would be subjected to a higher rate of tax than if the individuals invested directly. Because of this, it is provided in section 69 that certain corporations that meet specified requirements as to shareholders, investments, income and dividends, may pay tax at a special rate of 21 per cent (including old age security tax) which, when combined with the 20 per cent dividend tax credit, virtually eliminates the extra tax arising from the existence of the investment corporations. Representations were received by us that these corporations should not have to meet specified requirements as to investment to obtain this treatment, and that the treatment should recognize completely the conduit nature of such corporations.

Mutual Organizations

An anomaly of the present system is that whereas it subjects the income of ordinary corporations to "double taxation", it has only limited impact on the income of mutual organizations. Some of them, such as co-operatives and mutual general insurance companies, are able to take full advantage of the provisions in the legislation which permit the deduction of patronage dividends in arriving at the taxable income of the organization. Others, such as mutual life insurance companies, credit unions and caisses populaires, are not taxed at all. Our recommendations for such organizations are set out in Chapter 20.

SOME DEFECTS OF THE PRESENT SYSTEM

Aside from the question of the double taxation of corporate source income that is dealt with later, the foregoing brief description of the present system clearly demonstrates that it has serious defects. These defects are summarized below:

1. The failure to tax share gains has made it possible for shareholders to avoid or reduce personal income tax while realizing the retained earnings of corporations through:

   a) the sale of the shares of widely held corporations at prices that capitalized the retained earnings, or by

   b) surplus-stripping, or by taking advantage of the relieving provisions introduced to assist shareholders of closely held corporations.

2. The tax system has been strongly biased toward the retention of earnings by corporations with the result that the Canadian capital market is thinner and less developed than would otherwise be the case.

3. A corporation that relies on the issuance of new shares to finance its expansion, and hence has to maintain an adequate cash dividend

to avoid a reduction in the price of its shares, has been at a distinct tax disadvantage.

4. Shareholders controlling closely held corporations have had a tax advantage over other shareholders because they could limit the dividends of the corporations so as to minimize personal taxes.

5. It has been extremely difficult to prevent the abuse of the low rate of tax on the first $35,000 of corporate income by the splitting of a high income corporation into a number of non-associated corporations each of which is taxed at the low rate. Section 138A(2) may be more effective than prior attempts to meet the problem, but it is arbitrary and is uncertain in its impact.

6. In an attempt to restrict the avoidance of personal tax on retained earnings, the legislation has become increasingly complex and arbitrary, with the result that some legitimate business transactions have been deterred.

7. In particular, section 138A creates uncertainty, and the "designated surplus" provisions are often a barrier to mergers and reorganizations that have a useful business purpose.

All of these specific defects are quite apart from the arguments made against the present corporation tax on the ground that it is inequitable because it represents double taxation. To this question we now turn.

THE DOUBLE TAXATION ARGUMENT 10/

Under a neutral tax system all kinds of net gains, both realized and accrued, would be brought into the base and all would be taxed in the same way. There would be no distinction between the net gains from employment, from operating a business, from membership in a co-operative, from holding shares, bonds or other property, or from being a beneficiary under a trust. To the extent that the net gains from different types of activities and

from holding different kinds of property are subject to differences in tax treatment, the tax system distorts the allocation of resources.

As we have shown, the present tax system lacks neutrality in a multitude of respects. Nowhere is the lack of neutrality greater, however, than in the tax treatment of income from the corporate form of organization. Only corporate source income is subject to so-called "double" income taxes, under which income is taxed to the corporation and that part of corporate income distributed to shareholders is taxed again to them at personal rates without full credit for the corporation income tax. Examples of the effect of this double taxation are set out in Appendix E to this Volume. Other forms of organization, such as partnerships, proprietorships, co-operatives and trusts, are not faced with this double taxation (or can readily avoid it in the case of co-operatives).

The corporate form of organization offers some unique advantages. In particular, the corporate form has been found to be best suited for marshalling capital. Those economic activities that are dependent upon large pools of assets are unable to avoid double taxation by organizing as a partnership, proprietorship, trust or co-operative, except at the cost of paying a higher price for their capital.

To the extent that corporations pass on the corporation tax through higher prices for the goods and services they provide, or through lower prices for the goods and services they buy, consumers and suppliers buy fewer other things than they would otherwise be able to buy. This distorts the allocation of resources. To the extent that corporations do not pass on the tax through these price changes, their rate of return on investment is reduced and the allocation of resources to their economic activity is reduced (assuming that the shareholders could not avoid the extra tax by carrying out the activity through a non-corporate form). Thus, the tax on corporate income distorts the allocation of resources whether or not the tax is passed on 11/. Because of the corporation income tax, Canadians, as a

group, are less well off than they would be in its absence, assuming total government revenue is unchanged, because fewer of the goods and services they want are produced. Removal of the distortions created by the corporation income tax would mean that output would be greater so that some Canadians could be made better off without causing others to be worse off.

This question of double taxation and the "passing on" of the corporation income tax is so important and so controversial that we think it is essential to make our point of view abundantly clear. While we focus attention on the corporation income tax, it must be borne in mind that virtually all taxes can be passed on under some circumstances.

Three terms have to be carefully distinguished:

1. Tax avoidance, that is, changing the form of an activity, of an organization or of an asset to escape the tax that otherwise would apply.

2. Tax shifting, that is, maintaining after-tax income from a fixed (tangible) asset in the face of a change in the tax on that income, either by changing the selling price of the goods and services produced by the asset or by changing the prices paid for goods and services used in conjunction with the asset to produce the goods sold.

3. Tax-induced changes in the supply and allocation of fixed (tangible) assets among alternative uses, that is, maintaining the expected after-tax rate of return on fixed assets used for certain purposes or held by certain organizations by an adjustment of the relative quantity of the assets available.

The extent to which taxes can be avoided depends upon the structure and language of the statutes, the interpretation of the statutes by the courts and the knowledge of the taxpayer and his advisors. The extent to which taxes can be shifted depends, among other things, upon the competitive

position of the taxpayer and the state of the economy. The greater the degree of competition, whether from imported goods and services, from existing firms or from the possible entry of new firms, the more difficult it will be to shift tax increases forward through higher prices (or lower costs), or resist shifting tax reductions backward through lower prices (or higher costs).

The extent to which tax-induced changes occur in the amount of capital invested in a particular kind of fixed asset depends upon the nature of the asset and the speed with which the amount invested in the asset can be adjusted to changes in the expected rate of return. The supply of non-reproducible assets (such as a developed mineral deposit) obviously cannot readily be adjusted; on the other hand, the supply of some short-lived assets can quickly be adjusted simply by not replacing them. The adjustment can be rapid and complete or slow and incomplete, depending on the speed with which the total amount invested in an asset can be changed by changing the allocation of new savings among alternative investments.

When taxes are avoided by changing form without changing substance, tax shifting and tax-induced changes in the composition and amount of fixed assets do not occur. Similarly, when tax changes are not avoided, but after-tax income is maintained through shifting the tax, induced changes in the stock of fixed assets do not occur. However, when tax changes are not avoided and not shifted, the change in after-tax income from a particular kind of asset changes the expected after-tax rate of return on such assets. The search for the highest expected after-tax rate of return may induce a contraction or expansion in the amount invested in the particular kind of asset. Tax increases that lower expected after-tax rates of return on particular assets induce reductions in the amount invested in them. With the reduction in the amount of a particular kind of asset over what it would otherwise be, the supply of the goods or services produced by such assets is also reduced. This will usually increase the prices of the goods and

services produced by such assets (we ignore here the international aspect of the problem). With higher prices for the goods and services produced by such assets, the after-tax income and expected rate of return on the assets rises, and thus eliminates part of the initial impact of the tax change on rates of return. Conversely, tax reductions that increase expected after-tax rates of return on a particular kind of asset induce increases in the supply of such assets that in turn tend to reduce the amount by which the expected rate of return is increased.

While the present method of taxing corporate source income involves double taxation in the sense that the same dollars of income are taxed twice without full credit to the shareholder for the tax levied at the corporate level, the before-tax income of the corporation may have adjusted to the tax in one of several ways. The corporation income tax may have been shifted forward when it was imposed or increased. In that event shareholders would have been unaffected by the tax change, but consumers would have been subjected to a crude sales tax on goods and services. This sales tax would have reduced consumption or saving or both, and probably would have changed the pattern of consumption and hence the allocation of resources in a deleterious way. Because low income individuals and families consume a larger proportion of their income than others, a corporation tax, to the extent that it is shifted forward, is a regressive tax.

To the extent that the corporation tax or an increase in the corporation tax was not shifted, it must have changed expected after-tax rates of return to shareholders. The market value of the shares in corporations that were unable to shift the tax must have fallen. Those who held such shares at the time the tax was imposed, or increased, and sold them after they fell in price, would have suffered a capital loss at that time, and so in effect would have been subjected to a tax on their wealth. Those who purchased the shares subsequent to the tax change would have bought them at a price that capitalized the tax on the anticipated earnings of the corporation. Those who held shares at the time the tax was imposed, or

increased, and held them since that time, would also have suffered a capital loss because the after-tax income from their shares would have been reduced following the imposition or increase of the tax.

When a corporation income tax is imposed or increased, the cost of equity capital to corporations that are unable to shift the tax is raised (because of the decline in share prices) and the rate of investment by such corporations is lowered relative to what it otherwise would have been. With less investment and less output, the prices charged by non-shifting corporations tend to rise more rapidly, thus, over a period of time, bringing about a relatively greater increase in after-tax income and a corresponding recovery in the prices of the shares 12/. Other things being equal, when the adjustment to the corporation tax was complete, the relationship between the rates of return on all corporate shares and other assets, such as bonds, would be approximately what it was prior to the imposition of the corporation income tax 13/. The original equilibrium would thus be restored. If the adjustment was complete but the imposition of the tax changed rates of saving, risk preferences and other fundamental features of the economy, a different equilibrium would be reached, in which asset prices would bear a new, but stable, relationship to one another.

The main point, and it is an extremely important point, is that if the corporation income tax was not shifted, it was inequitable to those who held shares at the time the tax was imposed or increased, whether or not they subsequently held their shares or sold them. Those who bought shares following the imposition or increase of the tax did so at prices that capitalized the tax. The recovery in after-tax income that would generally follow the imposition of the tax would in many cases generate capital gains for those who accepted the uncertainty of the extent and timing of the adjustment and purchased shares at low prices soon after the tax was imposed. However, Canadians generally have lost through the taxation of corporate income at higher average rates than other income, even if the tax was not immediately

shifted, for the reduced investment in corporations that could not shift the tax distorted the allocation of resources. The stock of assets of the non-shifting corporations is less than it otherwise would have been. As a result, fewer goods and services of the kinds that Canadians want are being produced than would have been produced had there been no "double" taxation of corporate source income.

It is, of course, utterly impossible to rectify the inequitable consequences flowing from the "double" taxation of corporate income. The tax was first imposed in 1917, and the rates have been substantial for 25 years. No one knows who held particular shares at the time each increase in the tax took place, much less the extent to which particular shareholders in the past suffered capital losses because the tax was not shifted. Certainly it is impossible to compensate all consumers and suppliers for the corporation income taxes that were shifted at the time, and to compensate all Canadians for the reduction in the value of national output that has resulted from the lower rates of investment that subsequently have ensued. What we wish to emphasize is first, that the double taxation of corporate source income does not mean that present shareholders are being unfairly treated, and secondly, that the only relevance of the shifting question is in deciding to what extent the corporation income tax has been a crude sales tax and to what extent a crude tax on wealth.

This leads to the question of what would happen if the present system of taxing corporate source income was changed and the double tax effect removed. The converse of the previous analysis applies. To the extent that the reduction in the tax on corporate source income was shifted, consumers would be better off because the prices of some goods and services would decline, and suppliers (including employees) would be better off because the prices paid for some goods and services would increase. To the extent that the tax reduction was not shifted, some shareholders at the time of the reduction would obtain capital gains. Shareholders in corporations that did

not shift the tax reduction but which were not expected to be able to maintain prices for many years because of the entry of new firms, or because of the more rapid expansion of existing firms attracted by the higher after-tax rate of return, would have small capital gains. Shareholders in corporations that did not shift the tax reduction and were not expected to face strong competition from other corporations would have larger capital gains. These capital gains would be "unfair" in the same way that the capital losses created by the imposition or increase of the tax were "unfair". It is in this sense that the adage "an old tax is a good tax" is valid: even though it has had effects on the allocation of resources, the market has capitalized these effects, and removing the tax would give rise to unfair gains for existing shareholders.

Under our proposals the taxation of capital gains would to some extent offset the tax reduction and would mitigate the amount of the net gains after tax which the integration proposal in itself would produce.

Where increases in share prices occurred, however, the cost of capital to the corporation would be reduced and an expansion in the rate of capital formation for those corporations would be encouraged. This in turn would increase the future output of the goods and services produced by the affected corporations, would tend to reduce the prices of these goods and services and, over time, would bring about a relative reduction in expected after-tax corporate income toward its original levels, with a consequent reduction in the prices of the shares of these corporations relative to what they otherwise would have been. (It is not suggested that an absolute reduction in share prices would occur.) This reduction in share prices is the converse of the situation described above of the decline in price of a premium bond as it approaches maturity. The expansion in the output of these corporations would benefit all Canadians.

We recommend the abolition of the double taxation of corporate income, not to help existing shareholders, but primarily to obtain this additional

output and to eliminate differences in tax treatment between different kinds of organizations that inevitably provide opportunities for tax avoidance. The capital gains that some shareholders would obtain on the abolition of the double taxation of corporate income would be an undesirable, but inescapable, consequence of the proposal. In equity, these capital gains should be taxed at 100 per cent. In practice, it is not possible to distinguish these capital gains from other capital gains. However, it would be grossly unfair to allow the gains resulting from the integration proposal to escape being taxed at anything less than full rates.

Even with the taxation of capital gains at full rates, implementation of our integration proposal would probably give rise to gains to some shareholders. Since the overall net reduction in taxation of corporate source income would be offset by increases in taxation of income from other sources, these gains would in effect be financed by those whose taxes would be increased under our proposals. We believe that the financing of such gains to shareholders as may occur should be regarded as an investment by other sectors of the economy which would more than pay for itself as a result of the gains in future output that the implementation of our integration proposal should produce.

If the tax system is to be neutral, persons who carry on an activity through one form of organization should be subject to tax on the same basis and at the same rates as persons who carry on the same activity through another form of organization. As we have indicated, the corporation tax is probably shifted to an undetermined extent to consumers and suppliers. By the same token the tax imposed on an individual proprietor or on members of a partnership or syndicate may be shifted. The income taxes imposed on employees may be shifted, to some degree, to employers, and possibly by the employers to consumers and suppliers. There is no certainty that taxes are borne by the persons on whom they are imposed or that they are borne to the same degree by all persons on whom they are imposed. It is obviously impossible to measure the ultimate impact of a tax on all members of the community.

INTEGRATION AND CAPITAL GAINS

Although we do not wish to dwell upon the matter here, the relationship between the taxation of corporate income and the taxation of the gains or losses on corporate shares is very important. The failure to tax share gains in the past has undoubtedly reduced the adverse impact of the double taxation of corporate income. Without a tax on share gains, it frequently has been possible to arrange the form of transactions to avoid the full impact of the double tax. The earnings of the corporation generally could not escape the tax net, but by retaining the earnings in the corporation and selling the shares of the corporation at a price that reflected the additional assets of the corporation, the personal tax on retained corporate income could be avoided. To this extent the pressure to shift the tax was reduced, or the capital losses imposed on shareholders at the time the tax was imposed on the corporation were less. By the same token, removing the double taxation of corporate income would result in less reverse shifting or smaller capital gains to those who held shares at the time, if share gains were subject to full personal income tax. This is one of the reasons why we advocate **both the full taxation of property gains and the full integration of personal and corporation income taxes.** We could not **countenance the unwarranted benefits that some shareholders would obtain from full integration if share gains were not taxed in full; similarly, we could not accept the adverse effects of taxing share gains in full without removing the double** taxation of corporate source income. The two proposals are part of a package. Neither can be recommended in isolation.

THE EFFECTS OF THE INTEGRATION PROPOSAL

The proposed full integration of personal and corporation income taxes and the proposed full taxation of realized share gains would mean that residents would be taxed at progressive rates on the realized net gains from the ownership of shares in Canadian corporations. The net gains from the ownership of these shares would be taxed neither more nor less than the net gains from employment, from operating a business as a partner or proprietor, from holding real property, from holding bonds or from membership

in a mutual organization. The system would be neutral with respect to the retention of corporate earnings, and there would be neither tax advantages nor disadvantages as between equity financing and debt financing. The opportunities for tax postponement and avoidance would be reduced, for the form of a transaction would have much less tax significance. Several parts of the present law could be eliminated, while the uncertainty and complexity of other parts would be reduced. No other method of taxing corporate source income which we have considered has these desirable attributes.

Shifting

On the basis of the evidence we discuss in Chapter 4, we are doubtful that the implementation of the full integration proposal would result in substantial price reductions or cost increases in the short run. The evidence available suggests that Canadian corporation income tax changes have not been quickly and fully shifted even when they occurred at the same time as similar changes in the United States. Because implementation of the integration method would be unique to Canada, and because Canadian changes not matched by United States changes are less likely to be shifted, we do not expect that prices would fall or costs would rise sharply. As our earlier discussion suggests, increases in the prices of many shares would therefore be likely to occur, although the full taxation of share gains would substantially reduce the increase in share prices that would otherwise take place. This potential increase in share prices would also be restrained by the fact that a substantial proportion of Canadian equities is held by non-residents and our proposal for integration would have no direct effect on this group of shareholders.

As we will demonstrate later, the combination of our integration and full capital gains tax proposals would result in little if any tax relief for upper income shareholders, but would provide substantial tax relief for low and middle income shareholders. Upper income shareholders would benefit from the reduction in the top personal rate and from the fact they would pay no further tax on dividends when received. But bringing capital gains in full into tax could more than offset these benefits, for it has been estimated

that even after the exclusion of the portion of capital gains attributable to retained earnings, the capital gains that now escape tax are at least as large as the taxable dividends now received by those with large incomes. Therefore, the imposition of full personal taxes on such gains would, for the upper income shareholder, generally offset the effect of eliminating double taxation of corporate income.

Should the adoption of integration be followed by price reductions or wage and other cost increases, the after-tax income (broadly defined) of upper income shareholders would be further reduced as a result of our proposals. However, it is extremely unlikely that reverse shifting would occur to the point where low and middle income shareholders would not have a material net benefit. For low and middle income shareholders to be worse off, the tax reductions would have to be substantially over-shifted, that is, the average rate of return on shares would have to be sharply reduced. If this improbable event occurred it would not be permanent, for there would be a long-run adjustment through a reduction in the rate of investment that would gradually increase the expected after-tax rate of return on the shares of corporations where over-shifting had occurred.

The Demand for Canadian Equities

Low and middle income resident individuals would find the holding of Canadian equities under our proposal much more attractive than they do now. At the present time, $100 of corporate income bears a tax of approximately $50 in the corporation and no further tax if the remaining $50 is retained. The increase in share prices resulting from the retention is realized without tax to the shareholders except to the extent that the price has been discounted for the tax that will be payable on eventual distribution. The return to the shareholders is approximately $50, whatever the income bracket of the shareholders. Under integration, the corporate income retained would be allocated to shareholders and the cost basis of the shares held by them would be increased by the $50, so that the sale of the shares that had risen by $50 because of the retention would not produce a taxable gain. If the shares increased in price by more than $50, the excess would be the "goodwill" appreciation which would be subject to tax on the sale of the shares.

Because the resident shareholder in the top marginal rate bracket would be subject to tax on the allocation of $50, he would not have any additional tax to pay, nor would he receive any refund of tax paid. Thus, his after-tax return would still be $50. The low and middle income resident shareholder, on the other hand, would receive a rebate equal to the difference between the corporate rate of 50 per cent and his personal rate of tax at the time the retained earnings were allocated to him. Thus, a shareholder with a marginal rate of 20 per cent would receive an after-tax return of $80, rather than the current $50, that is, a $30 rebate of tax plus a $50 gain on the sale of the share. This gain would not be taxed because of the tax-basis adjustment already described. This great reduction in the weight of tax on corporate source income paid or allocated to low and middle income shareholders is one of the great advantages of our proposal. The reader is referred to Table 19-2 and Appendices M and N to this Volume for calculations of the differences in tax under alternative systems for shareholders in different income classes.

We propose that all intermediaries, including pension and other retirement income plans and life insurance companies, should be given full credit for the applicable corporation tax in respect of distributions or allocations on the shares of Canadian corporations that they hold. They do not now benefit from the dividend tax credit. This would be particularly important for Registered Retirement Income Plans, because we recommend elsewhere that these plans should not be taxed on their investment income or share gains but that the beneficiaries should be taxed on the full amount of any withdrawals. Such plans would therefore be entitled to a full refund of the corporation tax credited to them. Canadian equities, therefore, would be much more attractive to these plans than they now are. Individuals whose principal form of saving was through Registered Retirement Income Plans would not be denied the advantages of integration.

The benefits of integration would not be available to non-residents, except to the extent that they realized share gains that were a result of the capitalization of the expected benefits of integration. The tax position of non-resident shareholders of Canadian corporations would, in general, be

unchanged except to the extent that it would be affected by the recommended changes in the corporation tax base. However, the increase in Canadian share prices that should result from an increased demand for Canadian shares by Canadians could cause the dividend rate of return on Canadian equities to decline for non-residents relative to the dividend rate of return on non-Canadian shares. However, this does not necessarily mean that the total rate of return (gains plus dividends) on Canadian shares would decline, because the stimulus to capital investment might well cause Canadian share prices to increase more rapidly than the prices of non-Canadian shares. Also, the after-tax rate of return to non-residents would not necessarily be reduced. If Canadian corporations reduced their cash payouts in favour of non-cash distributions this would probably result in an increase in share prices as a reflection of the higher retained earnings, and would therefore result in the non-resident receiving a greater proportion of his income in the form of share gains, a change that could reduce his domestic tax liabilities. Although we would not expect non-residents to sell their Canadian shares quickly, because if they were subject to capital gains tax in their country of residence they would wish to postpone their tax on the share gain, nevertheless, over time a repatriation of Canadian shares would be likely to take place. This repatriation would probably not be sufficiently rapid to hold down the prices of Canadian equities.

The Supply of Canadian Equities

An increase in the price of Canadian equities, as a result of integration, would consequently reduce the cost of equity capital to Canadian corporations. Moreover, because the ultimate tax on residents would be the same on interest and dividends, the present tax bias in favour of debt financing would be substantially reduced. On both grounds, the attractiveness of equity financing to corporations would be increased and we would expect some increase in the supply of Canadian equities. The amount of the increase would, of course, also depend on other factors, such as the availability of

alternative sources of financing and the attitudes of those who control companies toward the dilution of equity and the possible effect on control.

There is, however, one feature of our proposal that would moderate this heavier reliance on the issuance of shares. Resident shareholders would be given full credit for the tax imposed at the corporate level on all corporate income allocated to them. As is indicated later, cash dividends would be only one of the methods available for the distribution of corporate income to shareholders for tax purposes. Because the allocation would not have to be by way of a cash dividend, the corporation could retain more cash without reducing the cash position of low and middle income shareholders, for these shareholders would obtain a rebate of part of the corporation income tax. In other words, the government would return part of the corporation income tax to those shareholders whose personal rates were less than the corporation income tax rate. Not only would this approach have the great virtue of making the tax system neutral with respect to the corporate decision of whether or not to retain income, but we expect that many public corporations could reduce their cash dividends without bringing about a reduction in the prices of their shares. These corporations would be forced into the equity market less frequently than at present to finance their present rate of capital formation. Generally speaking, we would expect the stimulus to capital formation to be sufficiently great to readily utilize the additional retentions and still make the raising of additional capital attractive.

The lower cost of equity capital in Canada which would be brought about by the implementation of the integration proposal should encourage Canadian corporations which were controlled by non-residents to issue shares in Canada. It is difficult to estimate the impact of this encouragement, for if the non-resident parent company was in no need of additional capital it would be indifferent to the attractive price obtainable on the sale of equities in Canada. Nevertheless, our proposal should have an effect similar to that sought by the Budget of 1963 without being open to the charge that

the position of non-resident direct investors had been adversely affected. The rules of the game would be changed, but in a way that would benefit the resident investor without harming the non-resident investor.

The Rate of Investment

To the extent that the reduction in the tax on corporate source income was not shifted backward through lower prices for goods and services or through higher costs for such things as labour, the reduction in the cost of capital would increase the rate of capital formation. This additional investment should in turn increase productivity, and thus bring about an increase in national output. Therefore, whether the reduction in tax was shifted backward or resulted in an increase in capital formation, Canadians as a group would be better off. This would be the principal benefit from integration.

Financing Integration

A reduction in the taxes on corporate income as currently defined would have a stimulating effect on investment and on the economy. However, to arrive at the net effect on the economy it is necessary to consider both the positive effects of the tax reduction and the negative effects of the tax increases that must be made elsewhere if revenues were to be maintained. This question is discussed later in this chapter and is explored more fully in Chapter 37. We can anticipate the results of those discussions by pointing out that we believe that the revenue cost of integration could be more than offset by taxing capital gains, by removing certain industry concessions and, in particular, the concessions to the life insurance and natural resource industries, by removing the dual rate of corporation tax and replacing it with a more efficient incentive for new and small businesses, and by reducing tax avoidance and evasion.

Our proposals for the taxation of corporate source income, taken as a package, do not involve reducing taxes on investors and increasing taxes

on non-investors. Rather, they involve a complex re-allocation of taxes among investors. Non-resident investors in small income corporations and in Canadian mining and oil corporations, upper income shareholders in small income corporations and speculators with gains in non-dividend paying shares would all be worse off. Low and middle income resident shareholders, particularly those holding shares in large income, dividend-paying Canadian corporations, would be better off.

The Dual Rate of Tax

We discuss in Chapter 22 and in Appendix I to this Volume the administration problems and the opportunities for tax avoidance that have abounded under the complex provisions related to the reduced rate of corporation income tax on the first $35,000 of corporate income. We believe that equity, neutrality and respect for the tax laws would be improved by ending this feature of the corporation income tax, and we are persuaded that our recommendation for the full integration of corporation and personal income tax would make this possible and desirable. Under our proposal, the ultimate tax on corporate income would be the personal income tax, and a flat-rate tax could therefore be imposed on all corporations with the assurance that resident shareholders would bear no more tax on corporate income than on any other income that they received. As we have explained, a flat-rate tax of 50 per cent, the same rate as the highest marginal rate of income tax under our proposed personal income tax rate schedule, would be necessary to avoid the tax deferment through corporate retentions which would be possible if the corporate rate were materially lower than the personal income tax. Small corporations having low income shareholders could distribute or allocate all of their income or, in order to avoid the need to remit tax at 50 per cent and then to have the shareholders claim a refund, a closely held corporation could take advantage of the option proposed elsewhere in this chapter of being taxed as a partnership. We propose other incentives (in Chapter 22) of a different character to encourage the growth of new and small businesses. Implementation of all these proposals would provide

more efficient incentives to new and small businesses, and would remove a concession that has often been abused. In any event, our proposal would ensure that no shareholder in a small income corporation would pay tax at a rate in excess of his own personal income tax rate. Because there could be no "double" taxation of corporate income, there could be no inequity.

Tax Avoidance Generally

Opportunities for tax avoidance usually arise where income derived through one kind of organization or in one form is given a different tax treatment than income derived through another kind of organization or in another form. This encourages taxpayers to change the organization through which income is earned or arrange transactions so as to obtain income in one form rather than another. Under the system we propose, income of a resident individual would be taxed in substantially the same way whether it was earned by him directly or was derived by him through a corporation, a trust, a partnership, a syndicate or otherwise. It would receive substantially the same tax treatment whether it was obtained in the form of employment income, dividends, partnership income or property gains. The possibilities of obtaining any substantial reductions or deferment of tax liability through changing the organization or the form of payment should be largely eliminated. We believe that the basic neutrality and equity of the system we propose would go a long way toward removing the problems of tax avoidance which have existed under the present system.

It would be naive to claim that our proposals would eliminate tax avoidance. Only in a country completely isolated from the rest of the world, with a tax system in which all accrued gains, imputed gains, and benefits in kind were brought into the tax base on the same basis as net gains realized in cash, would all avenues for tax avoidance be closed (assuming also that the deduction of personal expenses could be precluded). We obviously cannot create these conditions. Our proposals would, however, greatly reduce tax avoidance. Bringing the top personal rate into line with the corporate rate

would preclude the postponement of tax on retained earnings. This, plus the full taxation of share gains, would prevent surplus-stripping by resident shareholders and would obviate the need for many of the anti-avoidance provisions in the present legislation. The abolition of the dual rate of corporation tax would prevent the major abuses related to associated corporations. Full integration, the taxation of share gains and the proposed tax treatment of transfers of wealth would remove the differences in tax treatment which now exist between a non-personal corporation and a personal corporation, so that the latter status could be abolished.

Not only would implementation of our proposals eliminate the advantages of many present tax avoidance techniques, it would also make it possible to remove most of the barriers now in the Act that are designed to prevent avoidance of the double tax on corporate income. For example, the designated surplus provisions contained in section 28 which now impede legitimate mergers and amalgamations could be removed; and sections 105, 105A, 105B, 105C, and 138A could be withdrawn.

Equity and Neutrality Between Organizations

Implementation of our proposed system of taxing corporate income would make it possible to remove the disparities in tax treatment between different forms of organization. Corporations would be treated as favourably as co-operatives, trusts, partnerships and proprietorships. After hearing and examining the protracted "corporation—co-operative" debate, we believe this to be a very important advantage of the system we propose.

Committee-of-Four Proposal

Both the Canadian Institute of Chartered Accountants and the Canadian Bar Association suggested in their briefs to us a modified version of the proposal submitted to the government by the Special Committee on Corporation Taxation in 1961, hereinafter called the Committee-of-Four proposal 14/.

We therefore gave this method, and the proposed modifications, a thorough examination and careful consideration 15/. We recognize that adoption of the Committee-of-Four proposal would substantially reduce the surplus-stripping problem without resort to ministerial discretion—the problem with which the Committee was particularly concerned—within the context of the present statute. However, it would not resolve a number of the problems we have described and would not remove the inequities of the present system.

Fundamentally, the Committee of Four proposed that all corporate distributions should be subject to a tax at a flat rate of 15 per cent, with dividends tax free in the hands of shareholders. There would be no dividend tax credit. To reduce the impact on lower income shareholders, the Committee recommended that the 15 per cent tax collected at the corporate level on distribution should be refunded to shareholders with taxable incomes (including dividends) of less than $10,000. This, of course, would set up a sharp distinction between those with taxable incomes just under and those with taxable incomes just over $10,000, and would encourage the manipulation of income between years. However, our major objection to this proposal is that it fails to apply the same schedule of progressive rates of tax to corporate source income as to other income 16/. In terms of our criteria, the proposal would tax shareholders in different income groups unfairly relative to one another. The double taxation of corporate income is an undesirable feature of the present system and one that the Committee could not have been expected to correct within their terms of reference.

The Committee of Four also proposed that as an incentive to certain Canadian corporations to distribute their earnings to Canadian resident shareholders, a special tax abatement should be allowed to such corporations equal to a percentage of dividends paid to Canadian shareholders out of earnings after December 31, 1960. It was suggested that the rate of abatement should be reviewed annually, with an initial suggested rate of 10 per cent.

This would have the effect of reducing the overall taxes on amounts distributed to resident shareholders. However, since the tax abatement would be allowed to the corporation it would benefit non-resident shareholders as well as resident shareholders. The greater the percentage of non-resident shareholders in a corporation, the less would be the percentage benefit obtained by the resident shareholders.

We considered how the Committee-of-Four proposal might fit into a structure that taxed capital gains and had a lower top personal income tax rate. We explored a number of alternative methods of combining this approach to the taxation of corporate income with different approaches to the taxation of capital gains.

It was apparent that if the Committee-of-Four method of taxing corporate income was adopted, the full taxation of share gains would be completely unacceptable. Unless corporations capitalized their retained earnings through the issuance of stock dividends (with an appropriate increase in the cost basis of shares to avoid taxing both the retained earnings and the share gains attributable to those earnings), the weight of tax on corporate source income with the full taxation of capital gains would be increased inordinately. After-tax rates of return on shares would be depressed and the cost of equity capital would be increased, with a consequent depressing effect on capital formation by corporations. Such a system would be both unfair and incompatible with economic growth.

The obvious alternative was to combine the Committee-of-Four proposal with something similar to the United States approach to capital gains: the taxation of the full amount of share gains at one-half personal rates up to a maximum rate of tax of 25 per cent, although with a top personal rate of 50 per cent this upper limit would not have to be explicit. We have not included in this alternative the special tax abatement for distributions to Canadian resident shareholders which was recommended by the Committee of Four, particularly since it was not recommended by either the Canadian

Institute of Chartered Accountants or the Canadian Bar Association. This is termed the "alternative" system in the balance of this section of this chapter. We rejected this alternative on the grounds discussed below.

In our evaluation of the alternative system, we assumed that to minimize the taxes payable by shareholders, most corporations would capitalize their retained earnings by the issuance of stock dividends, and that the cost basis of shares would be increased accordingly. We also assumed, following approximately the recommendations of the Committee of Four, that shareholders with marginal rates below, say, 35 per cent would be refunded the 15 per cent tax on corporate distributions, whether the distribution was in stock or cash.

The impact of this alternative approach relative to the present system and the system we propose for shareholders with different marginal rates can be readily demonstrated. A recent United States study found that over the period 1926 to 1960 an equal investment in every company with shares listed on the New York Stock Exchange would have yielded an average before-tax return of 9 per cent compounded annually 17/. It is reasonable to assume that dividends accounted for about one third of this return, share gains resulting from retained earnings accounted for another one third, that is, that dividends averaged one half of net profits, and the remaining one third arose from what might be called a "goodwill" capital gain 18/. The period covered by the study included the depression of the 1930's and post-World War II experience; if the postwar period alone were considered, the return would be substantially higher and the proportion of the total gain arising from goodwill gains would be substantially greater.

Assuming that the cash pay-out policies of corporations would not change and that the estimates given above would hold, the tax on the $9 annual return to the shareholder from a share costing $100 is shown in Table 19-2 under the three alternative procedures for taxing corporate source income.

TABLE 19-2

PERSONAL AND CORPORATION TAXES PAID ON AN ANNUAL NET GAIN OF $9.00 PER SHARE UNDER THREE TAX SYSTEMS, FOR SHAREHOLDERS WITH DIFFERENT MARGINAL RATES

	Marginal Rate of Shareholder					
	20 Per Cent			50 Per Cent		
	Corporate Level	Personal Level	Total Tax	Corporate Level	Personal Level	Total Tax
Present System	$	$	$	$	$	$
$3.00 dividend ($6.00 corporate income before tax)	3.00	0.00 a/	3.00	3.00	0.90 a/	3.90
$6.00 share gain arising from:						
$3.00 after-tax corporate income retained ($6.00 before tax)	3.00	0.00	3.00	3.00	0.00	3.00
$3.00 "goodwill" capital gain	0.00	0.00	0.00	0.00	0.00	0.00
Total tax	6.00	0.00	6.00	6.00	0.90	6.90
Alternative System Including Tax at One-Half Rate on Capital Gains						
$3.00 dividend ($6.00 corporate income before tax)	3.00	0.00 b/	3.00	3.00	0.45	3.45
$6.00 share gain arising from:						
$3.00 after-tax corporate income retained ($6.00 before tax) c/	3.00	0.00 b/	3.00	3.00	0.45	3.45
$3.00 "goodwill" capital gain	0.00	0.30	0.30	0.00	0.75	0.75
Total tax	6.00	0.30	6.30	6.00	1.65	7.65
Integration and Full Taxation of Share Gains						
$3.00 dividend ($6.00 corporate income before tax)	3.00	-1.80	1.20	3.00	0.00	3.00
$6.00 share gain arising from:						
$3.00 after-tax corporate income retained but allocated ($6.00 before tax)	3.00	-1.80	1.20	3.00	0.00	3.00
$3.00 "goodwill" capital gain	0.00	0.60	0.60	0.00	1.50	1.50
Total tax	6.00	-3.00	3.00	6.00	1.50	7.50

The following assumptions were made in constructing this table:

1. Before-tax corporate income of $12.00 per share.
2. Corporation income tax of 50 per cent.
3. Dividend of $3.00 per share.
4. "Goodwill" capital gain of $3.00 per share.
5. The capital gain is realized.

Notes: a/ After deduction of 20 per cent dividend tax credit.
b/ It is assumed that the 15 per cent tax on distributed earnings is refunded to shareholders with marginal rates below 35 per cent.
c/ To avoid taxing share gains arising from retained earnings that have borne tax at the corporate level, it is assumed that corporations issue stock dividends that have the same tax consequence as cash dividends. This minimizes the tax burden under this alternative.

Under the foregoing assumptions, the alternative system and the proposal we recommend would have virtually the same effects on the tax position of shareholders with marginal rates of 50 per cent. In both cases, taxes would be raised by about the same amount relative to the present system. However, it should be pointed out that if, as we believe, the foregoing estimate of the proportion of goodwill gains to total gains understates the "true" picture, the difference between our proposal and the alternative approach for upper income shareholders would narrow and possibly be reversed. The greater the goodwill gain in proportion to the total gain, the less would be the tax levied under the alternative, while the tax under our proposal would remain unchanged.

Under our proposal, the increase in tax would be the net result of a reduction in the tax on corporate earnings and an increase in the tax on the goodwill gain. Under the alternative system, the tax on corporate earnings would be unchanged relative to the present system, but the goodwill gain would be taxed less heavily than under our proposal.

The major difference between the two methods is the treatment of the low and middle income shareholder. The present system greatly overtaxes the low and middle income shareholder relative to the upper income shareholder if the progressive rate schedule is used as the standard. The alternative approach reduces this vertical inequity. Our proposal removes it entirely. Another difference is that our proposal would make holding Canadian equities more attractive to low and middle income resident individuals and less attractive to upper income resident individuals. The alternative approach would make holding Canadian equities less attractive for all but those upper income individuals who are now paying extremely high marginal rates on their cash dividends. The alternative system might therefore tend to depress share prices and discourage capital expenditures by corporations. Certainly it would perpetuate the adverse effects on resource allocation that characterize the present system.

We are convinced, therefore, that our proposal is more equitable than the alternative approach. The alternative approach would lead to inequities because most dividends would be taxed at flat rates and capital gains at half rates. Low and middle income shareholders would be overtaxed relative to upper income shareholders, and all would pay too little tax on goodwill gains relative to a neutral system. In addition, we have the following objections to the alternative system:

1. With the alternative system, it would be difficult to abolish the dual rate of corporation tax, for, to the extent that small income corporations had low income shareholders, it would be inequitable to levy a tax of 50 per cent on corporate income at the corporate level with no subsequent credit to the shareholder for this tax. On the other hand, to maintain the dual rate would permit some upper income shareholders to derive corporate source income with the payment of tax at less than personal rates and would leave in existence the associated-company problems Canada now has.

2. Taxing capital gains at one half the regular rates would perpetuate the present difficulties involved in trying to separate capital gains from income gains. As we point out in Chapter 15, as long as this distinction remains the law will be both uncertain and complex and will place a premium on the adjustment of form to avoid taxes.

3. The lack of neutrality in the tax treatment of different forms of organization would remain.

4. Unless the "one-half tax rate on capital gains" approach were confined to corporate securities, gains on real property and other capital assets would be taxed at one-half rates only. We see no justification for this concession to other property gains.

5. It would leave opportunities for tax avoidance.

In the light of these findings, we concluded that the Committee-of-Four approach to the taxation of corporate source income, even with the partial taxation of property gains, is irreconcilable with our basic concept of equity, would be administratively complex when combined with the partial taxation of share gains and would lack neutrality.

OTHER ALTERNATIVES

We propose now to examine some other alternatives to our proposal and our reasons for rejecting them. This is done only briefly here; an analysis of these alternatives is given in Appendix F to this Volume.

Allow Dividends as a Deduction

The allowance of dividends paid as a deduction from corporate income seems a reasonable alternative. It would partially meet some of the defects of the present system, mainly by encouraging distributions and thus limiting the attractiveness of surplus-stripping. Its main drawback, however, would arise from the deduction of dividends paid to non-residents. The allowance of such deductions would result in unwarranted revenue costs and would serve to increase the amount collected by foreign treasuries. We reject the possibility of overcoming this by a withholding tax equivalent to a combination of the present corporation income and withholding taxes, for such a substantial withholding tax, regardless of the underlying circumstances, would obviously be unacceptable to some of the countries with which it would be necessary to renegotiate tax treaties. Restricting the deduction to dividends paid to residents would be imperfect in impact because the benefit of the deduction would flow to all shareholders, both resident and non-resident. In addition it would pose administrative problems.

Treat Corporations as Partnerships

An alternative at the other extreme would be to deem that all corporate earnings were distributed to shareholders and therefore were subject to

personal income tax as earned. This proposal is in many ways similar to the approach we recommend and would end all problems arising from the retention of earnings such as tax deferment and surplus-stripping, but it would create other problems. A complete and theoretically consistent allocation of the year's income would require that the various persons who had held the shares of the company for varying periods during the year would be allocated their share of the year's income. This would be extremely difficult. In addition, the final order or priority of the rights of individual shareholders would have to be settled every year for the sharing of the year's income among them. This might be contrary to contractual arrangements already in existence. Liquidity problems would be created for shareholders deemed to have received substantial amounts of income in a year in which it was not possible for the corporation to pay out cash. The latter difficulty could be avoided by levying a substantial withholding tax, but again this would probably be unacceptable to other countries. In any event, this alternative would not provide an acceptable basis for the taxation of income flowing to non-residents.

We do recommend later in this chapter that in some cases an election could be made that a corporation be taxed as if it were a partnership. However, we suggest that the right to make this election should be subject to restrictions which should overcome the difficulties referred to above in cases where the election was made.

Exempt Distributions from Further Tax

Another alternative would be to continue the corporation income tax but to exempt distributions from any further tax when received by shareholders, that is, to apply only the corporation income tax to corporate earnings. This solution is wholly inconsistent with our view that equity requires that progressive rates of tax be applied to a comprehensive income base that includes income from corporations, and it cannot be entertained for that reason.

Increase the Dividend Tax Credit

The dividend tax credit could be increased to reflect more closely the rate of corporation tax. With a refund of tax to the lower income groups, a tax credit equal to the corporation income tax would achieve reasonably close integration, but would not produce the same adherence to progressive tax principles as the system we recommend. The main defect of such a system would be that it would fail to achieve the complete identity of the income of the corporation in the hands of the shareholder that would result from including in the shareholder's income the grossed-up amount of the dividend before corporation income tax was paid. By including only the dividend in the income of the individual, an amount of corporation income equal to the tax paid by the corporation would be excluded from personal income, an exclusion that would increase in value as the income of the shareholder increased. Thus, the dividend tax credit approach is essentially more valuable to upper income than to lower income shareholders.

Levy a Special Tax on Retained Earnings

Finally, we considered levying additional taxes on retained earnings in lieu of, or in addition to, corporation income tax. A variety of schemes is possible, including a flat-rate corporation tax and additional rates of tax of, say, 5 per cent to 20 per cent on undistributed earnings of the corporation. A flat-rate tax is inequitable because it is not progressive. It would meet the requirement of reducing the advantage of tax deferment through retention, but it would require the more general use of stock dividends or it would run the grave risk of creating tax pressure for the increased distribution of cash to the detriment of capital investment. We favour a tax system which is neutral between retention and distribution of cash. A tax on undistributed earnings, if it exceeded the tax on distributions, would create a bias in favour of distributions. The proposal we recommend would remove existing impediments to distribution rather than impose a tax penalty on retentions.

TREATMENT IN OTHER COUNTRIES

Appendix G to this Volume contains a summary of the tax treatment of corporate source income in the United Kingdom, France, Germany, and the United States. Although we also examined the treatment in other countries, we have referred specifically to these four because their systems are representative of the general approaches being followed in industrial countries. The United Kingdom and France are of particular interest because they have recently adopted major changes in this area, each country moving in essentially the opposite direction to the other.

In the United States the corporation is taxed as a separate entity, with a dual rate of tax similar to that presently existing in Canada. All corporate profits are taxed whether distributed or retained. Since 1964 no credit for the corporation tax has been extended to the shareholder. Prior to that time the shareholder was entitled to a 4 per cent dividend tax credit, which was reduced to 2 per cent for 1964 and thereafter eliminated.

In Germany, a distinction is made between distributed and retained earnings, with the former subject to a tax of 15 per cent at the corporate level while retained corporate profits are taxed at 51 per cent. Resident shareholders are not eligible for a tax credit for any part of the tax paid by the corporation.

Prior to 1965 France taxed all corporate profits, whether distributed or retained, at 50 per cent, and taxed dividends received by individuals at full personal rates without any credit for any part of this corporation tax. Then in 1965, to encourage economic growth by stimulating private investment and saving, the government introduced legislation, to become fully effective as of January 1, 1967, to extend to resident shareholders a gross-up and credit for one half of the corporation tax paid. The corporation tax is to remain at 50 per cent; but the amount to be included in the income of shareholders for dividends received is to be 150 per cent of the

dividend, with the extra 50 per cent to be claimed as a tax credit. This credit is to be refundable to the extent that it exceeds the tax liability of the shareholder. Thus, in effect one half of the corporation tax paid will be deemed to have been paid on behalf of resident shareholders. This contrasts with our proposal to treat the full amount of the corporation tax in this fashion. In addition, corporations are to be encouraged to distribute profits within five years of the year earned by a provision that requires them to pay an additional tax equal to this 50 per cent credit on any distributions from profits earned more than five years prior to the year of distribution.

In contrast to the French approach, the United Kingdom in 1965 moved away from their system of a substantial integration of the corporation and personal income taxes to a system involving a flat rate, non-creditable tax on the corporation. In essence, this ended the procedure of collecting the standard rate of tax of approximately 40 per cent at the corporate level and then requiring the shareholder to gross-up his income to include this tax paid on his behalf. The corporate profits tax, which was in general levied at a rate of 15 per cent, was also eliminated, and instead a flat-rate corporation tax of 40 per cent was imposed, with no credit being allowed to shareholders on dividends received. Thus, while the tax liabilities of the corporation have been reduced from about 55 per cent to 40 per cent, resident shareholders have lost the credit for tax at the standard rate which was formerly paid on their behalf by the corporation. The declared primary purpose of this change was to encourage corporations to reduce distributions and to invest the funds retained in capital expansion. In addition, the Chancellor of the Exchequer criticized the previous system as being unnecessarily complex, awkward to vary for economic purposes and subject to abuses and anomalies.

Thus, both the United Kingdom and France have introduced major changes in the taxation of corporate source income essentially to encourage private investment. In both cases the goal is to provide additional funds for

corporate expansion, but the methods employed are diametrically opposite to one another. In France, the incentive is extended to the shareholder; in the United Kingdom, to the company. Before the effects of any shifting or reverse shifting, after-tax rates of return are to be increased in France and lowered in the United Kingdom. However, the cash flow of the corporation will initially be increased in the United Kingdom, while it will remain unchanged in France.

The criticism levelled by the Chancellor of the Exchequer at the former system in the United Kingdom has significance for our recommendations. We have examined in detail the avoidance and administrative problems encountered under the former United Kingdom system, and are satisfied that our proposals encompass solutions for these problems. In particular, our proposal would only permit a tax credit to the shareholder for taxes actually paid or deemed to have been paid by the company. Our recommendations are sufficiently flexible to permit the use of any kind of tax incentive or disincentive. In addition, we feel that our proposed single flat-rate tax at the corporate level, when accompanied by the full taxation of share gains, would be relatively simple to administer when compared to a multi-tax approach with preferential rates for different kinds of income. Our proposal would limit the top personal rate to approximately the corporate rate and so would not be subject to the anomalies and complications which have resulted from the United Kingdom surtax. Finally, we believe that the best encouragement to economic growth in Canada would be to facilitate the most efficient allocation of resources and that this would be accomplished by levying taxes on corporate source income that were as neutral as possible in their effects.

SOME FURTHER ASPECTS OF OUR PROPOSAL

At the beginning of this chapter we described briefly the essential features of our integration proposal and the relationship between that proposal and the taxation of all property gains at full rates. The purpose of this section of the chapter is to explain some of the major technical

attributes of the proposal in greater detail. For still further information about its technical features, the reader is referred to Appendix H to this Volume.

Essentially our integration proposal is a method of collecting from the corporation the corporation tax on all corporate income at the top personal rate, and then providing full credit to resident shareholders for the portion of this corporation tax applicable to the corporate income paid or allocated to shareholders. Because most resident shareholders would obtain a refund, because no resident shareholder would pay additional tax at the personal level and because the credit also would apply on a non-cash allocation to shareholders, we believe that virtually all corporate earnings of companies controlled by Canadians would be paid or allocated to shareholders on an approximately current basis.

To keep the gross-up and credit procedure simple and understandable for shareholders, it is suggested that in any special cases where corporate income is taxed at less than 50 per cent, the corporation should be required to pay additional taxes or withholding taxes in order to bring the total tax paid or deemed to be paid by the corporation on all distributions of income to resident shareholders up to 50 per cent, so that the gross-up and credit on all distributions from the corporation would be at the same rate for the shareholder. The shareholder, either corporate or individual, would therefore always receive credit for the full rate of corporation tax, and this would keep the complexities involved in ensuring that the proper tax had been paid within the corporation where they could be handled most readily. In particular, this approach would facilitate the accounting for intercorporate dividends. This approach is not a necessary feature of the full integration system, but it is one that we recommend because we believe it would be feasible and preferable to the alternative techniques.

Another important feature of the integration system is the adjustment of the cost basis of shares. Corporate income which is allocated to

shareholders (by one of several methods described later) would be brought into income like a cash dividend, but the shareholder's cost basis of his shares would be increased by the amount of the earnings retained. Therefore, increases in share prices resulting from the retention of earnings would not be subject to tax on realization.

It should be kept in mind that the integration proposal relates to resident shareholders only. Non-resident shareholders would not receive any credit for the corporation tax and would be subject to withholding tax on distributions (but not on allocations) on much the same basis as at present.

Various Forms of Eligible Distribution

We have reviewed a variety of means by which a resident shareholder could become entitled to a gross-up and credit. We contemplate that there could be four principal methods, three of them not requiring the distribution of cash. We emphasize that each method would have the effect of allowing a full credit to the shareholder for the corporation income tax. Some of the methods would require an adjustment of the cost basis on the relevant shares. The methods we recommend are as follows:

1. Cash dividend (including a dividend in kind): full gross-up and credit; no adjustment in the cost basis of shares.

2. Stock dividend: full gross-up and credit; increase in the cost basis of the shares, including the shares issued as the stock dividend, by the amount capitalized in the corporation's accounts.

3. Other procedures involving a capitalization of surplus: same treatment as stock dividend.

4. Allocation of taxed income without capitalization: same treatment as stock dividend except that in the corporate accounts the amount distributed would not be capitalized and there would be no increase in the number of shares outstanding. We discuss later the reasons for this procedure and its technical aspects.

These methods of distributing or allocating corporate income that has borne tax are all discussed in detail in Appendix H to this Volume. By way of further brief explanation here, it may be said that under method 3 above, we would include the payment of dividends in debentures or other obligations of the company. Also, under this method, where shares without par value were outstanding, any effective transfer of income to capital stock account would be regarded as a capitalization. Under this procedure no new shares or obligations would be issued, but the company would notify the shareholders as to the action taken. The possibility we have in mind under method 4 is simply the transfer of income to an appropriately designated account which might be called "allocated surplus". This would result in a deemed dividend for tax purposes. Under this last method, no new shares or obligations would be issued but the shareholders would be notified of the action taken.

It will be apparent that the proposals just made would have implications for corporate accounting, as would the proposals which we will later put forward for the treatment of foreign income, corporation tax incentives and transitional undistributed surplus. Some types of distributions would result in the resident recipient being entitled to the gross-up and credit for tax purposes; others would not. Implementation of our overall proposals would imply allocation of corporate surplus among accounts according to the tax consequences for the shareholder of a distribution from those accounts. We have set forth explanations of these matters in Appendix H to this Volume.

One aspect of corporate distributions that merits special comment is the order of pay-out of the various categories of corporate surplus and capital. Under the present law most distributions, except those made on the retirement of redeemable preferred shares, are deemed to be made out of undistributed income as long as there is any undistributed income on hand. Such a requirement is a necessary protective feature of a tax system which attempts to levy both a corporation tax and a personal income tax on corporate earnings. Under the system we propose, however, the corporation tax would be

analogous to a prepayment of personal income tax and, because a distribution would usually result in a tax credit to the resident shareholder, it would be in his interest to have a distribution deemed to be taxable. Nevertheless, it would be useful to have a stipulated order of priority in which corporate distributions are to be made, as is discussed in Appendix H to this Volume. It should be provided, for example, that distributions and allocations would be made out of taxed income to the extent of such income and that further distributions would be by way of return of capital.

We also believe it would be desirable that so far as shareholders were concerned there should only be two types of distributions, those made out of taxed income which would be grossed-up at the corporate rate and on which credit would be allowed at the corporate rate, and those made as a return of capital which would not be included in the shareholder's income but rather would reduce the cost basis of his shares.

Distributions out of taxed income would include all dividends, capitalizations and allocations made out of income which had been subject, or was deemed to have been subject, to corporation income tax but had not previously been distributed. Distributions not made out of taxed income, but which represented a return of capital, would include distributions made out of income previously allocated, distributions made out of surplus existing at the transitional date on which the legislation came into effect and distributions made out of other financial surplus which was not subject to corporation income tax.

Because some types of corporate income, such as income from foreign sources and possibly income which was treated in a special way under incentive legislation, may be taxed at less than the normal corporate rate, the corporation should be required to pay sufficient additional tax on making a distribution out of such income so that all of the income being distributed would have borne tax at the full corporate rate. The shareholders would then gross-up the distribution and would obtain credit on that basis. It would

also be possible to provide that corporation income tax would be deemed to have been paid on particular kinds of income so that the shareholder would be entitled to gross-up a distribution and obtain credit for the corporation tax as if it had been paid. This may apply in cases where a credit was given for foreign tax paid or where an incentive was granted to corporations in the form of an exemption from tax which the government wished them to be able to pass on to their shareholders. Procedures for accomplishing these objectives are discussed in Appendix H to this Volume.

It would be necessary to make provisions with respect to various types of distributions other than those referred to above. This would be a matter for the legislators, but we suggest that some types of distributions should be dealt with along the following lines:

1. A distribution on liquidation should be treated as a distribution out of taxed income of the corporation to the extent of such income, and the balance should be treated as a return or realization of capital.

2. A distribution on the redemption or purchase for cancellation of shares or on a reduction of share capital should be treated as a return or realization of capital to the extent of the amount paid up on the shares; any excess over that amount should be regarded as a distribution of taxed income to the extent of the shareholder's portion of the corporation's taxed income; and the balance, if any, should be treated as the proceeds of a realization of the shares.

3. A conversion of shares into another class of shares should not be treated as a distribution unless it resulted in a capitalization of surplus, in which case its treatment would be as outlined above. A conversion of shares into obligations of the corporation should be treated in the same way as a redemption.

4. No special provisions would appear to be required for loans to shareholders, since there would be no tax advantage in making such loans.

The above rules would apply to distributions to resident shareholders. In the case of non-residen shareholders different considerations would apply and the rules with respect to distributions to them should remain very much as they are at present.

These suggestions are obviously not complete, but they indicate the general approach which we believe should be taken.

Allocation of Income

Our proposed procedure for the allocation of taxed income without capitalization is new, and care would have to be taken in its implementation. An allocation would be effected by action of the board of directors of a company and would have significance only for tax purposes. The purpose of this procedure would be to permit the shareholders to obtain the benefit of a distribution for tax purposes without a distribution actually being made. We consider this procedure to be necessary in order to achieve the objectives of integration and avoid the double taxation which would result if taxable gains arising on the sale of shares reflected a substantial amount of income which had been subject to corporation tax that had not been credited to the shareholders. In the case of many corporations it may not be feasible to capitalize all of their retained earnings. Such a capitalization would presumably involve the payment of withholding tax by non-resident shareholders who obtained no benefit from integration. It might also result in tax complications for non-resident shareholders under the tax laws of their own countries. Even companies without non-resident shareholders might be reluctant to capitalize all of their after-tax undistributed earnings annually since this would restrict their freedom to declare dividends in the future. Accordingly, in order that our proposals be fair and workable and neutral with respect to the distribution or retention of corporate earnings, we believe it is important to permit the allocation of taxed income without distribution.

It would, of course, be necessary to provide that when income had been allocated, a subsequent distribution of the same income would not again be included in the income of the shareholders. Such a subsequent distribution should be treated as a return of capital. When an allocation was made, the net amount allocated to a shareholder should be added to the cost basis for his shares. When a distribution was made out of income previously allocated, it should be applied to reduce the cost basis of the shares.

Where shares were held in the names of brokers or banks or other nominees, administrative problems may arise with respect to allocations, as they would with respect to other distributions. These problems would be simplified to some extent by the requirement which we recommend for each taxpayer to report in his return the securities which he owned and the transactions which he had during the year. Since it would be in the interest of resident shareholders to obtain the benefit of any allocations on shares which they owned, the responsibility should be placed on the shareholder to establish that he was entitled to the benefit of such an allocation in respect of any shares which were not registered in his name. This should encourage more resident investors to have their shares registered in their own names.

One question that arises in connection with this procedure concerns the fact that the persons to whom an allocation was made may not be the persons who would eventually receive the distribution. Shares change hands from time to time, and additional shares of a particular class may be issued. However, this situation should not produce any inequity. The full amount of realized capital gains and losses would be included in the computation of income. An allocation would result in an increase in the cost basis of shares and would be taken into account in computing the gain or loss on the disposition of shares, while a distribution of income previously allocated would result in a corresponding decrease in the cost basis and would likewise be taken into account in computing the final gain or loss on disposition. Therefore, we do not believe that any distortion would result from the fact that an allocation may be made to one person while the corresponding distribution was subsequently made to another holder of shares of the same class.

However, if it was possible for an allocation to be made to the holders of shares of one class and the corresponding distribution to be made to the holders of shares of another class, then there might be opportunities for the deferment or avoidance of tax. Accordingly, the rules relating to allocations should prevent this possibility in most circumstances. For example, they should provide that an allocation could only be made to the persons who would have received a dividend if one had been declared at the time the allocation was made. They should also provide that an allocation could not be made to the holders of shares of a class which carried a non-cumulative dividend only, unless that dividend was actually paid before the right to it expired. Later in this chapter and in Appendix H to this Volume we discuss some further provisions which may be necessary to prevent tax avoidance or deferment through the use of the allocation procedure.

Corporate Incentives

The implications for shareholders of any tax concessions received by corporations would depend on the total impact the government wished to achieve through its measures. We particularly have in mind temporary measures that the government might wish to enact from time to time as part of stabilization policy, such as accelerated or deferred depreciation, or a subsidy or tax reduction equal to a proportion of investment expenditures.

Under our proposal, a number of possibilities would remain open to the government that could be used for any particular programme. The amount of the benefit, once identified in the accounts of the corporation that are suggested in Appendix H to this Volume, could be passed on to the shareholders as a dividend having no implications for the cost basis of shares, as a distribution of capital requiring a reduction in the cost basis of shares, and so on. The government would select that alternative which best met the particular objective it may be attempting to achieve in any given situation. However, it should be emphasized that, although we agree that there are circumstances when tax incentives are appropriate, we are strongly opposed to any incentive that involves a general exemption of income at the corporate level or that would have the effect of creating new, permanently exempt forms of income for the shareholder.

Foreign Income

In Chapter 26 we deal at some length with the various considerations bearing on the Canadian tax treatment of income received by a Canadian corporation from outside Canada and in turn distributed to its Canadian shareholders. Therefore, we discuss the matter only briefly in this chapter where our particular concern is with the implications for the integration proposal of the foreign origin of some part of Canadian corporate income.

Our main conclusion in Chapter 26 is that, in order to maintain a reasonable balance between the tax results of domestic and foreign investment by Canadians, we must recommend some integration of foreign taxes paid on income which was subsequently distributed to resident shareholders by a Canadian corporation. However, this integration must be limited to ensure that at least some Canadian taxes were collected on foreign source income. In arriving at our recommendations we have noted that the present dividend tax credit, which is a form of partial integration, is granted without distinction as to the origin of the income being distributed and therefore is applicable to foreign source income.

Our foreign tax credit proposals for business income received from a foreign direct investment operation have three major features. Details and definitions are contained in Chapter 26.

1. Foreign source direct investment income should be subject to income tax of at least 30 per cent on an accrual basis, that is, in the year it is earned. If foreign taxes paid do not reach this level, then a special tax equal to the difference should be paid in Canada by the Canadian direct investor, either corporate or individual.

2. The net business income earned or dividends received (after any withholding tax) from foreign direct investment should be grossed-up at a 30 per cent rate, with the aggregate amount included in the income of the Canadian direct investor, either corporate or individual, and the 30 per cent recorded as the amount available as a tax credit.

3. Where foreign direct investment income is earned or received by a corporation, an additional tax equal to 20 per cent of the grossed-up foreign source income should be withheld from amounts distributed or allocated to shareholders out of foreign source direct investment income. This additional tax would facilitate the record keeping for corporate distributions by bringing the total tax credit available to resident shareholders up to 50 per cent. This tax should not be payable on distributions to non-residents.

If such income were to be subject to a gross-up and credit at a 30 per cent rate, few Canadian shareholders in receipt of income from a Canadian corporation with income from direct investment abroad would be worse off than at present, and low and middle income shareholders would be absolutely better off. Therefore, we recommend this rate of gross-up and credit for foreign direct investment. It should be noted that, in order to avoid application of different rates of gross-up and credit to different portions of a dividend, we propose that, at the time of making a distribution or an allocation to resident shareholders from foreign source direct investment income, a Canadian corporation should pay a withholding tax sufficient to bring the total tax attributable to the foreign source portion of the dividend up to the 50 per cent that would have been levied on the portion earned in Canada. This mechanical device would enable the shareholder to gross-up all dividends received at the 50 per cent rate and also to claim a tax credit at that rate. As we have already indicated, it would be necessary to establish rules as to the order in which income from different sources was distributed, so as to determine the time at which this additional tax would be payable. In Appendix H to this Volume it is suggested that distributions should be regarded as having been made on a pro rata basis from the grossed-up income which had been subject to full corporation tax and from the grossed-up foreign source income.

Carry-Over of Losses

Because losses cannot be allocated to shareholders in the same manner as income, their identification with the shareholders is less direct. In the case of losses which were deemed to be of a personal nature, their deductibility would be limited so that the shareholder would be required to bring a deemed benefit into income in the same way as any other expenditure at the corporate level that was deemed to result in a personal benefit to a shareholder. In the case of ordinary business losses, the loss could be carried back by the corporation up to the amount of the income of the previous two years that had not been paid or allocated to the shareholders. Any unabsorbed balance of the loss could be carried forward indefinitely against future income, subject to the limitation referred to in Chapters 9 and 22 that is designed to prevent the deduction of losses deemed to be personal in nature. To the extent that the losses reduced share values, the shares could be revalued downward. The resultant loss could be claimed as a deduction from other income by the individual shareholder, who would also have the usual averaging privileges we recommend in Chapter 13.

Intercorporate Dividends

When the shareholder was a resident corporation, the procedure would be the same as for an individual, that is, a grossed-up dividend from another taxable resident corporation would be brought into taxable income and the related tax credit would be deducted from the resulting tax. If, however, the receiving corporation incurred a loss on its other operations, the loss could be applied against the dividend and a refund could be claimed. These procedures would result in the top personal rate of tax being imposed only once, regardless of the number of corporations involved, with an eventual credit for the applicable corporation tax to the individual shareholder upon distribution or allocation to him of the taxed income.

Special Corporations

There would appear to be no further need for the present provisions concerning personal corporations. The shareholders of such corporations could avoid any overpayment of tax on the corporate income by having the corporation make a high level of distribution or allocation to its shareholders. On the other hand, underpayment of tax would be prevented by virtue of the high level of corporation tax already imposed on the income flow. The present provisions regarding investment corporations would also seem to be unnecessary. Life insurance corporations would follow the same procedure as ordinary corporations in respect of corporate distributions received. Because of the unique nature of their business the tax treatment of insurance companies is dealt with more fully in Chapter 24.

Other Canadian Recipients

The tax treatment of dividends paid to pension funds and other forms of retirement income plans is discussed in Chapter 16. The income of Registered Retirement Income Plans would be exempt from tax, and they would be entitled to a full rebate of tax already paid in respect of dividends received from taxable resident corporations. The income of non-registered plans would be allocated to beneficiaries, to whom these plans would be entitled to pass on the tax credit.

The treatment of dividends paid to charities, private clubs, and other types of special corporations is dealt with in Chapter 20.

Preferred Shareholders

We recommend that dividends on preferred shares should be eligible for the normal gross-up and credit. The reasons for this treatment are the same as those that resulted in the eligibility for the present dividend tax credit being extended to preferred dividends. It is impossible to distinguish classes of shares in such a way as to allow a deduction for dividends paid

on "pure" preference shares. Accordingly, such dividends are paid from after-tax income and the credit should be provided. We recognize that because the dividend on preferred shares is fixed, the extention of the gross-up and credit for corporation tax paid to such shares would greatly increase the after-tax yield on presently outstanding preferred shares and that as a result they would increase in value. However, we are satisfied that this increase in value would not be excessive, because our studies show that almost 90 per cent of the outstanding Canadian preferred share issues carry a fixed redemption price and, in the event of a material rise in values, such issues would probably be redeemed.

In our view, interest on income bonds, which is not deductible by the paying corporation under the present law, should be eligible for the same treatment as dividends on preferred shares.

Non-Resident Shareholders

If the general practice among countries was to "look through" the corporation for tax purposes, so that the residents of foreign countries would be treated in a manner similar to what we propose for residents of Canada, a reconciliation of the Canadian and other national schemes of taxation might be possible. In fact, however, the usual approach in other countries is to tax corporations as separate entities and, accordingly, it would be impossible to extend to non-residents on a reciprocal basis a treatment comparable to that which we propose for residents. However, we are satisfied that, generally speaking, non-residents should not have grounds for complaint regarding our proposals, because the proposals generally would not increase the weight of tax on non-residents compared with the present system.

One exception to this statement should be mentioned. Many non-resident shareholders could be adversely affected if the corporations in which they held shares increased their level of distribution by issuing stock dividends. This might be the case in the United States, where such stock dividends are

generally excluded from income (until they are disposed of or redeemed and a capital gain or income results).

While their position is not entirely clear, a non-resident portfolio investor might lose the tax credit for the Canadian withholding tax on a stock dividend or capitalization. A non-resident corporation which is a direct investor is often permitted to claim a foreign tax credit in respect of dividend income for the underlying corporation taxes paid by a Canadian subsidiary as well as the withholding tax. If the payment of a stock dividend caused either of these tax credits to be lost, then the direct investor would also be adversely affected. We would recommend, therefore, that the Canadian authorities undertake to negotiate future treaty arrangements to provide specifically, at least for direct investors, that either stock dividends be treated, at the election of the non-resident, as ordinary dividends, so that they would carry the full tax credit, or that the non-resident have the right to obtain credit for the withholding tax (and where applicable for the underlying corporation income taxes) against his tax payable on a subsequent sale or redemption of the shares.

In any event, we have provided for this situation until such time as a suitable solution can be found. Under our proposal a Canadian corporation having substantial foreign ownership could avoid declaring stock dividends and could achieve the same result for its Canadian shareholders, without any unfavourable consequences for non-residents, by employing the procedure for an allocation of surplus. No withholding tax would be payable on such an allocation.

Dividend Taxation Related
to Share Gain Taxation

The relationship of corporate earnings and retentions to share gains and losses is discussed elsewhere in this Report but may be touched upon

again here. It is our belief that the very substantial incentive which the implementation of our proposal would create for the distribution or allocation of corporate income, either in cash or non-cash form, would virtually eliminate the influence of retained earnings on taxable share gains and losses.

Under our proposal, corporations controlled by Canadian shareholders would have every reason to allocate corporate earnings to shareholders approximately as earned, for most resident shareholders would benefit by receiving a tax credit or rebate and none would be hurt by such allocations. Virtually all earnings retained in the corporation would, therefore, have been distributed or allocated to shareholders by means of stock dividends, or by one of the other procedures we have described. Because non-cash distributions or allocations to shareholders would be added to the cost basis of the shares, increases in share prices that resulted from retained corporate income would not be taxed on the disposition of shares. This can be readily illustrated by a simple example. Suppose that an individual with a marginal rate of 30 per cent buys a share for $100. Suppose that corporate earnings before tax are $20 a share and that the corporation retains the $10 of after-tax income, but allocates this amount to the shareholder. The shareholder would bring the grossed-up value of the $10 retention, that is $20, into his income, would calculate his tax as $6 and would obtain a refund of $4. In addition, he would increase the cost basis of his share from $100 to $110. If the share price rose by the amount of the cash retention and the share was subsequently sold for $110, there would be no taxable gain because there would be no difference between the adjusted cost basis of $110 and the selling price of $110. Therefore, while the retention of earnings would continue to generate increases in share prices as they do at present, the adjustment of the cost basis would mean that this part of the gain would not be brought into income.

A shareholder wishing to sell his shares prior to a distribution date would endeavour to recover in his selling price the expected distribution

in order to net the same amount as if he had held the shares. The income distribution would then be "capitalized" in the price of the shares, and the purchaser who received the distribution should incur an offsetting reduction in the value of the shares upon subsequent resale. There are, of course, other factors affecting share values, and it would be hard to isolate the above effect in the ordinary market transaction. However, with a higher level of distribution and higher tax credits, this factor would be more important than it is at present.

If share values did drop simultaneously with a distribution, the purchaser of the shares would have a "wash" transaction (no gain or loss), for the distribution included in income would be offset by an equivalent loss on the shares, and the personal tax on the income would be collected through taxing the vendor's gain on the sale of the shares. This is appropriate, because the income would have accrued while the vendor held the shares, and would be reflected in the gain he realized on disposition of his shares. We discuss these and other economic implications of integration at greater length in Chapter 37.

Corporate Acquisitions and Reorganizations

The system we propose would achieve a reasonable balance of the tax consequences of a sale of shares for both vendor and purchaser. We are also satisfied that the system we propose would achieve substantial neutrality as between a purchase of shares and a purchase of assets as a result of the combined effect of the taxation of gains on the disposition of property, the taxation of gains on the disposition of equities, and the great reduction in the importance of undistributed income. In addition, the purchaser of all the shares in a corporation should be allowed to revalue the underlying assets, other than goodwill, to their market value, in order to establish a current basis for capital cost allowance. Another contributing factor would be the proposed deduction of interest on money borrowed to acquire shares, the present disallowance of which gives an

additional bias toward the purchase of assets. Under our proposal interest costs would be allowed in either case. The fact that companies would be less likely to accumulate large amounts of undistributed income, and that undistributed income could be eliminated for tax purposes through allocations of income in non-cash form, should facilitate corporate recapitalizations and reorganizations.

Closely Held Corporations

Mention should also be made of the effect of integration on the shareholders of closely held corporations. Under the present tax system such companies have encountered severe problems because of the inherent tax liability on accumulated surplus and because of the difficulty encountered in distributing a substantial amount of cash to an estate, often for the purpose of paying estate tax, without giving rise to substantial income tax. Under our proposals, methods would be readily available to all such companies to make adequate provision for most of their tax problems. The realization of share gains on death would create a tax liability for the difference between the cost basis of the shares and their market value, including the goodwill element. However, if closely held companies and their shareholders took advantage of our various proposals by making regular allocations of earnings and thereby obtained credit for corporation tax and an upward revision in the cost basis of the shares, the impact of the disposition on death should be reduced. In any event, there would no longer be a potential tax liability on the distribution of accumulated surplus and it would be possible for a company to make a large cash distribution to an estate without giving rise to any tax liability. In addition, the full deductibility of interest costs would permit the company to borrow in order to make the necessary cash distribution on redemption of senior securities.

Shareholder Information

The shareholder should be provided each year with a T5 statement listing the following details to the extent applicable:

1. The amount to be included in income.

2. The tax credit in respect of the amount to be included in income.

3. The amount of cash distributions.

4. The amount of non-cash distributions (to be added to the cost basis).

5. The amount that was a return of capital, including proceeds of redemptions of shares, dividends paid out of previously allocated surplus and dividends paid out of surplus on hand at the transition date (to be deducted from the cost basis).

Determination of the Rate of
Corporation Income Tax Credit

Under a system of grossing-up the dividend and of allowing a credit for the corporation income tax, the selection of the corporation income tax rate eligible for the credit is obviously of importance. Should it be the rate of tax for the current year or the rate of tax over a period of years? We recommend that it should be the rate of tax applicable to corporate income in the year of the distribution or allocation. The normal situation would be that dividends would be declared principally from current income, and our proposal would therefore conform with the general case. It would also greatly facilitate both public understanding and ease of calculation if the grossing-up and crediting were to take place at the current rate. Under our proposal for a 50 per cent corporation income tax rate, the dividend paid in the year would be grossed-up by doubling the net dividend, the resulting amount would be included in taxable income, and a credit of 50 per cent of the amount of the grossed-up dividend would be deducted from the personal income tax of the shareholder.

When the rate of corporation income tax is changed, which for reasons outlined later should not be often, we recommend that the gross-up and credit on future distributions should take place at the new rate until a

further change is made. Details of the adjustments to be made by corporations in their accounts in this connection are set out in Appendix H to this Volume.

Option to be Taxed as a Partnership

With the introduction of integration and a single rate of tax for corporations, corporations with shareholders in the lower tax brackets would pay tax at the rate of 50 per cent, while the shareholders would be entitled to obtain refunds at a later date. In the case of a large, well-financed corporation this should not impose any hardship, but in the case of many small, closely held corporations it might cause financing problems. It seems to us that there should be a simpler method of allocating income to the shareholders in such cases, so that they would not be required to go through the procedure of paying tax at the 50 per cent rate and then claiming refunds. It is also our view that where feasible, corporate losses should be allocated to these shareholders, rather than to require that they be applied only against other corporate income.

Accordingly, we propose that certain corporations should be permitted to elect to be taxed as partnerships. If such an election was made, the corporation would pay no tax, but the shareholder would include his pro rata proportion of the profits of the corporation in his income and pay tax thereon in the normal manner (but, of course, without the use of the gross-up and credit formula). He would also increase the cost basis of his shares by the amount included in his income. When dividends or other distributions were paid out of the income attributed to the shareholders, such distributions would be free of income tax but the amount received by each shareholder would be applied to reduce the cost basis of his shares. If the corporation sustained a loss, the shareholder would be entitled to

deduct his pro rata proportion of the loss from his other income, and this amount would be applied to reduce the cost basis of his shares. In this case, the corporation would not be permitted to carry the loss back or forward.

It would be necessary to establish certain restrictions and requirements in order that the provisions could be readily administered and would be as free as possible from anomalies. The following are examples of requirements which might be imposed, although additional conditions would undoubtedly be required:

1. The election for any taxation year would have to be made by the corporation at any time within that taxation year or within 90 days thereafter. An election once made would be effective until revoked or until the corporation ceased to fulfil all the necessary conditions.

2. The election would be made by filing a form to be prescribed by the tax authorities and based on the prior approval of the holders of at least 90 per cent of the outstanding shares of the corporation. The election could be revoked by action of the board of directors or by the action of the holders of a majority of the shares of any class.

3. The income of the corporation for the taxation year in question, as determined in the usual way, could not exceed, say, $200,000.

4. The election would not be permitted if the corporation had more than fifteen shareholders at any time during the taxation year, or if any of the shares of any class were owned by non-residents at any time during the year.

5. An election could not be made unless all income of the corporation for prior years in which the option was not elected had been distributed or allocated. This would mean that all dividends paid in the

year by the corporation would be paid out of income which was or had been included in the incomes of the shareholders and accordingly would be treated as a return of capital.

6. If the corporation had more than one class of shares outstanding and the holders of any class were entitled to a non-cumulative dividend, none of the income would be allocated to the shares of that class unless the dividend was paid.

Particular consideration would have to be given to problems arising from the transfer of shares during the course of the year. It might be possible to apportion the income attributable to shares transferred during the year on a per diem basis. Alternatively, it might be necessary to withhold the right to be taxed as a partnership where a transfer of shares was made at any time other than at the year end.

SOME PROBLEMS IN THE PROPOSAL

We have arrived at the proposal advanced in this chapter after an exhaustive consideration of the defects of the present Canadian system and of various alternative systems. It meets more closely than any other alternative the objective of a comprehensive base taxed at graduated rates, and provides a means of curing the most troublesome of the problems that have plagued the taxation of corporations for half a century. We believe that it is the best solution that could be put forward.

Despite our confidence in our proposal, we are fully conscious of the fact that we are dealing with one of the most complex and controversial areas of taxation, and we are under no illusions that we have produced the perfect answer. It is incumbent on us, therefore, to point out and evaluate some of the objections that might be advanced against our recommendation.

Rigidity

It might be said that our proposal would introduce an element of rigidity into the tax system by requiring that the corporation income tax rate and the highest marginal rate of personal income tax should be either identical or should be separated only by a small margin. To accomplish the results we hope for, there must not be a substantial gap between the two rates. In support of this feature of our proposal we would suggest that, the absence of a tax on share gains, the lack of integration of the corporation and personal income taxes and the divergence between the two rates have been the main sources of tax avoidance efforts in the past. Introduction of a tax on share gains would remove much of the problem, but a complete solution to the problem of tax deferment as it concerns resident shareholders would involve either adopting our proposal or giving up the personal tax on corporate distributions, an alternative we find unacceptable. More important, under a system of full credit for corporation income tax, the rate of corporation income tax would determine the amount of credit or rebate which Canadian shareholders would obtain from the government. Thus, the rate would become considerably less significant than at the present time, and the element of rigidity would be of relatively little consequence.

Federal-Provincial Relations

Our recommendations have important implications for federal-provincial relations. It is obvious that any solution must take this matter into account, and in Chapter 38 we put forward proposals for overcoming the main difficulties.

Tax Avoidance

In view of the importance of the tax credit or tax rebate under our proposal, one method of fraudulently exploiting the system would be to use fictitious dividend notice slips. The prevention of this would require

strict control over the issuance of T5 slips by corporations, with severe penalties for non-compliance with the official regulations introduced for this purpose. An additional check would also be provided from the record of assets to be filed by individuals that we recommend in Chapter 15.

If shares were transferred at artificial prices between residents who were in different tax brackets, the allocation provisions might permit deferment of tax liabilities unless there were special provisions to prevent this. If such a transaction was between a resident and a non-resident, then the appropriate tax liability might be avoided in the absence of a preventive provision. Accordingly, there should be a provision to the effect that if shares were acquired otherwise than in a bona fide transaction between parties dealing with each other at arm's length, the transfer would be deemed to have taken place at the fair market value and the transferor would have made a gift to the transferee equal to the difference between the actual price and the fair market value. If the shares were transferred by a resident shareholder to either a resident or non-resident purchaser in an arm's length transaction at less than the fair market value under an agreement or option or pursuant to some other right, additional provisions would probably be necessary to prevent tax avoidance or deferment. These suggested provisions are discussed in Appendix H to this Volume.

Transactions between Residents and Non-Residents

Another possibility for abuse of the system of integration would arise as a result of transactions between residents and non-residents. Dividends received by a non-resident from a Canadian corporation would be subject to a Canadian withholding tax and in some cases an additional tax payable by the non-resident to his own country. However, any resident individual to whom the non-resident sold the shares could receive the distribution, could probably avoid having any income by reselling the shares (because the income distributed would be offset by the loss on the resale of the shares) and could therefore obtain a refund of all or part of the corporation tax already

paid. Even if the non-resident were taxed in his own country on the gain realized upon selling his shares to the resident, there could still be a sufficient tax reduction to make the arrangement worth while. The protection provided within Canada against such procedures would lie in the full taxation of share gains, but this would not reach non-residents. The net result of this avoidance procedure would be that Canadian tax on the corporate income accruing to the non-residents who participated would be reduced.

The source of this potential problem is the accumulation of unallocated tax credits that, although they were attributable to the shares held by the non-resident, would be of no benefit to him otherwise than through a "stripping" operation. Because the non-resident could not receive any benefit from these credits in the ordinary course of business, measures taken to eliminate the accumulation would not have an inequitable effect on the non-resident. Therefore, the legislation might include a provision that restricted the accumulation of tax credits on taxed income that was attributable to non-residents. Alternatively the Act might require a corporation that was controlled by non-residents to allocate any income that was not distributed within one or two years of the year in which it was earned. This measure would not result in any liability for withholding tax, but would prevent the accumulation of unused tax credits. Such an approach might well be extended to all companies in which non-residents held a major interest, and would ensure that Canadian minority shareholders would obtain the benefits of integration. It may also be necessary to have a provision to the effect that if shares were transferred by a non-resident to a resident in such circumstances that the resident had not obtained a bona fide interest in the business or property of the corporation, but only a temporary interest, no refund would be paid to the resident on a distribution or allocation. This should inhibit artificial transactions under which non-residents would sell the shares temporarily to residents in order to obtain a reduction of the effective tax rate.

Interest Paid to Non-Resident
Shareholders

Another avoidance possibility would be that non-residents who controlled a Canadian company might effectively avoid the corporate rate of tax by the use of interest-bearing obligations instead of equity investments. Because virtually all interest payments would be deductible under our proposals, contrary to the present treatment that prohibits the deduction of interest on funds borrowed to acquire shares on which the dividend income is exempt, avenues for abuse would be opened. For example, a new subsidiary might be set up with a loan capital of $1,000,000 and invested capital of $100. When net earnings (after interest) reached a point where material Canadian taxes were payable, the shares of the Canadian subsidiary could be sold to another newly formed Canadian subsidiary at a price which would represent the capitalized value of anticipated earnings, and the new company would again have a very high ratio of debt. The simplest solution to this problem of interest payments by a Canadian corporation to non-resident investors with whom it did not deal at arm's length would be to deem such payments to be dividends, an approach that would be similar to that followed in the United Kingdom. Thus, they would not be deductible and would be subject to withholding tax at the rate applicable to dividends 19/. We recommend that this course should be followed, at least in a number of well defined cases.

Transitional Problems

The implementation of our proposals for the integration of the personal and corporation income taxes poses some major transitional problems. These involve the timing of the introduction of the proposed changes, the treatment of surplus on hand at the effective date of the legislation and the problem arising from the probable temporary reduction in revenue during the period immediately following the introduction of the proposals.

Timing of Proposed Changes

One important question relates to the time at which the various proposals for integration of the personal and corporation income taxes and the full taxation of capital gains would be introduced. We believe that the greater the initial step and the fewer the subsequent steps, the less would be the total market disturbance. The impact of the immediate introduction of the full taxation of all asset gains would be eased by the fact that tax would apply only to the portion of the gain accrued after the transition date. Because share values are primarily related to future earnings, a lowering of the future tax, with an increase in the net after-tax return, would bolster share values and help to offset the depressing effect of a tax on share gains. Immediate introduction of these changes would have to be accompanied by a reduction in the top rate of personal income tax and also the provision of special measures for small businesses previously entitled to the lower rate of corporation tax.

Our conclusion favouring the immediate implementation of the bulk of our proposals runs counter to the assumption, valid in most circumstances, that substantial changes should be introduced gradually. In a gradual approach, we foresee a repetition of disturbances equally upsetting at each step and a series of technical adjustments of extreme complexity. For example, the introduction of the tax on share gains by a gradual extension of the portion of the gain to be included in income would be a disturbing factor in the market for several years as it sought to adjust to each new change. A single step making the full change would probably be no more disturbing if accompanied by all the other reforms we have proposed. This question of a gradual introduction of some of the proposals is discussed below in connection with one of the possible procedures put forward as a transitional provision.

For non-resident shareholders the transitional considerations are quite different because the proposed changes in the Canadian tax treatment of share gains and corporate income do not affect them directly. Accordingly,

whether future distributions to non-resident shareholders came out of existing surplus or future surplus would be of no importance; the same withholding tax should apply to any distribution.

Treatment of Surplus on Hand at the
Date of the Legislation

Under the present system, the general intention has been to collect tax on the undistributed income at the time it is distributed, and to permit capitalization after payment of a special tax (section 105). But we have seen that this intention has been frustrated by the various ways of making distributions free of tax or at low rates of tax through surplus-stripping procedures. An attempt could be made in the future to collect tax upon distributions of surplus existing at the transition date. But it would be necessary to employ a method that did not perpetuate the inequity of the present system which grants an advantage to shareholders of those corporations that retain surplus indefinitely. Furthermore, it must be kept in mind that no onus has hitherto been placed on a corporation to make distributions of income as earned. On the contrary, both the tax system and the needs of the economy have favoured the retention of earnings for reinvestment. The assumption has been made in the past that tax deferment through the retention of earnings was not a concern of the authorities and that no opprobrium was attached to it.

It is our view that shareholders should not be allowed the benefits of integration on corporate earnings retained in the past. The portion of these accumulated earnings that was applicable to residents should be regarded as capitalized so that future distributions to residents from such surplus would be free of personal income tax. The procedure would be to treat a distribution from this surplus as a partial realization of the shares, and therefore to reduce the cost basis of the shares by the amount of such a distribution. Because the share value would probably decline by a similar amount, this approach would prevent such a distribution from creating a deductible loss on the shares.

Problems Arising from Temporary Reduction in
Tax Revenues from Corporate Source Income

The initial impact of the proposed integration procedure would probably cause a number of shareholders who held shares at the time of the change to benefit from windfall increases in the price of their shares, despite the depressing influence on share prices of the proposal for the full taxation of share gains. More important, integration itself would result in an initial loss of tax revenues that would only be offset after a number of years by the other measures that we propose for taxing corporate source income and share gains. This latter temporary impact is significant. If overall government revenues were to be maintained in the transitional period (an objective set by our terms of reference) and if a change in the taxation of corporate source income would result in a temporary revenue reduction (our other proposals for corporate source income would more than offset the deficiency once the transitional period had elapsed), it would be necessary to develop some additional, but temporary, source of revenue.

The problem of the immediate windfall gains would be partially resolved if the full taxation of share gains was implemented before the market anticipated the favourable effects of integration. Shareholders who experienced large share gains from the adoption of our integration proposal would at least be taxed on such gains at full personal rates. However, since it would probably not be possible to arrange the timing of the taxation of share gains in this fashion, there would likely be some untaxed windfall gains. A transition tax on shareholders, which temporarily depressed share prices, might serve to reduce these windfall gains. A transition tax on shareholders would also moderate the impact of our proposals on the stock market if such a transitional measure did not bear as heavily on those industries most severely affected by the removal of special concessions.

The full taxation of share gains would reduce the buoyant effect of integration, but we do not expect that the offset would be complete. On balance, share prices should rise, although there would be substantial

differences between the changes in the share prices of different corporations. Generally speaking, shareholders of corporations with the following characteristics would have the greatest share gains:

1. Corporations in a monopoly or quasi-monopoly situation that would not shift the tax reduction through lower selling prices or higher purchase prices; and

2. Corporations that had been expected to make relatively large taxable distributions to their shareholders in the future.

Unfortunately, there is no simple, consistent and objective measure of either characteristic that would make it possible to impose heavier taxes on the shareholders of such corporations in order to limit the windfall gains from integration or to reduce the after-tax benefit from such gains. There are so many determinants of share prices that are constantly changing that it would be impossible to determine with confidence the extent to which particular share gains resulted from integration. We are recommending many other changes in the tax system that would add to or subtract from the effects on particular corporations of our proposals for integration and the full taxation of gains.

As we have already indicated, integration would produce a revenue loss that presumably would have to be recouped elsewhere in the tax system. Over the long run the full taxation of share gains would provide much of the necessary increase in revenue. The removal of most of the special industry and business tax concessions would more than make up the balance. In the long run, as discussed in Chapter 35, the total tax revenues from corporate source income would be moderately greater under our proposals than under the present system. The simultaneous adoption of integration and the full taxation of share gains would, nevertheless, result in a temporary revenue loss because integration would reduce revenue immediately while the full taxation of share gains would increase revenue only gradually. The realization of

share gains would be postponed by shareholders, but share losses, through revaluation, if not realization, would probably be taken into account in the year they arose. In addition, we have proposed that the removal of special industry tax concessions should be done gradually over a period of years so that again the potential increase in tax revenue would not be realized immediately.

The question, then, is whether this temporary deficiency in tax revenue should be ignored or be offset by a temporary increase in tax on all income or whether it should be offset by a temporary tax on corporate source income. The general economic conditions at the time would be critical in assessing the first alternative. The last alternative would have the advantage that it would bear on those who would obtain the direct benefit from integration, that is, the shareholders, but the economic impact would be uncertain and there would be administrative difficulties in imposing such a tax. The second alternative, on the other hand, does not appear to be unreasonable. A transition tax on all income would not be an inequitable burden on the non-shareholder, for he would benefit not only from the general effects of integration already discussed but also from an eventual increase in the tax revenue from corporate source income.

Whatever method is adopted for making up the temporary loss in revenue resulting from integration should, in our view have the following characteristics:

1. It should provide overall equity among resident shareholders;

2. It should not have a retroactive impact or place an undue burden on corporations;

3. It should not affect non-resident shareholders since they would not benefit from integration; and

4. It should not be unduly cumbersome or complex.

The only alternative to a special transition tax which we considered and which would have these characteristics was a procedure that amounted to a gradual introduction of our integration proposal. Under this alternative, our other recommendations (e.g., the changes in the tax base, including the full taxation of property gains) would be implemented at once to achieve immediately the consequent improvements in equity and ease of administration. Corporate distributions would be grossed-up to the full amount of the tax at the corporate level, but the shareholders would not be allowed to immediately claim the full corporation tax credit. Instead the credit would be increased gradually over, say, three years from 35 per cent to 40 per cent to 45 per cent and then to 50 per cent in the fourth year. This time period could not be too long. An extended transitional period would create unfavourable distortions with share gains taxed in full and distributions still subject to some double tax. It would also encourage manipulations in profits and distributions to defer the latter until the full gross-up was available.

Although this alternative does not involve a loss of any of the major administrative advantages of our overall proposals, it does pose some administrative difficulties. Not only would the changes in the gross-up rate be confusing to some shareholders, but under this "solution" to the transitional problem it would either be necessary to stipulate and enforce a minimum level of distributions, in order to prevent corporations from merely delaying distributions until the full credit was available, or special adjustments would be required in the corporate records to account for the changes in the gross-up rate. In any case it would be necessary to ensure that corporate profits were computed exactly each year because of the extra value placed on a one- or two-year deferment of "income". Thus, the determination of receivables, liabilities, and other items would be particularly significant, and there would be administrative difficulties in applying the provisions to inter-company dividends. Special alleviating provisions would be needed for small businesses because they would have lost the low rate of corporation tax without the offsetting compensation of full integration. Finally, this alternative would have a similar impact on all companies, whether old and established or new and growing.

It would delay the impact of full integration on new and rapidly expanding companies, a delay that we seek to avoid with the alternative proposed. The solution of a special transition tax, although not without its own difficulties is, we believe, preferable.

One type of special tax that could be used to raise the necessary revenues while also carrying out to some extent the existing intention to levy a second tax on all corporate profits, would be a once-and-for-all flat-rate tax on all existing surplus. The payment would be amortized annually over a long period of time to ease the impact. Because the retained earnings of Canadian corporations at the end of 1964 amounted to over $20 billion, a tax thereon of, say, 5 per cent spread over 5 years would produce at least $200 million in revenue a year.

While in some respects this might appear to be the logical way to carry out the basic purpose of the present system, we find it unacceptable. Although the levying of an additional tax of over $1 billion on Canadian corporations as a group over the next five years would have a relatively minor impact on many corporations, it would no doubt have serious effects in some instances. In addition, many corporations have had no intention of ever distributing this surplus, so that such a tax would be a completely unexpected burden. This tax would also bear on non-residents and, although the 15 per cent withholding tax could be waived on distributions from this tax-paid surplus, it would nevertheless have an unfavourable impact on many non-resident shareholders, an impact which we do not consider would be fair.

Having considered various alternative procedures, we have concluded that if there was to be a special transitional provision to make up the temporary deficiency in tax revenues caused by our recommendations for corporate source income, it should be a general measure applicable to all income of resident individuals. In Chapter 35 we discuss several alternatives for raising revenues in the transitional period. If it was thought that the required revenues should be raised by a measure specifically applicable to corporate source income, the transition tax described in Appendix J to this Volume would be recommended.

CONCLUSIONS AND RECOMMENDATIONS

1. Taxes can be collected from organizations such as corporations but the burden is ultimately on people—customers, employees, suppliers or shareholders—whose power to consume is reduced by the tax on the organization. Corporations have the rights and obligations of persons under the law; management often makes corporate decisions without consulting the shareholders. These are valid but irrelevant propositions in considering who bears the corporation tax.

2. Equity and neutrality could best be achieved under a tax system where there were no taxes on organizations, and all individuals and families selling and holding interests in organizations were taxed on the realized and accrued net gains derived from these sales and holdings. The net gains from selling and holding interests in organizations would be treated in the same way as other kinds of net gains, and the net gains from selling and holding interests in all kinds of organizations would be taxed identically.

3. Unfortunately this ideal system cannot be recommended for two reasons:

    a) At the present time, valuation problems preclude the annual taxation of accrued net gains. In the absence of accrual taxation, and if there was no tax on the income of corporations, some individuals could postpone their personal income taxes on the income they wished to save.

    b) If the Canadian corporate source income of non-residents was taxed at lower rates than are now in effect, it would reduce the net benefit Canada derives from foreign direct investment in Canada. Because of existing tax treaties and the retaliation that would follow if these treaties were ignored, it would not be feasible to tax this income at the present level except by a corporation income tax like the tax now imposed at a rate of approximately 50 per cent.

4. Retaining the corporation income tax at a rate of approximately 50 per cent, but providing full integration of this tax with the personal income tax of residents, would solve the deferment problem, would maintain the net benefit from foreign direct investment in Canada and would achieve the greatest possible equity and neutrality.

THE PROPOSED INTEGRATION SYSTEM

5. The basic features of the full integration system we recommend are as follows:

a) The income of corporations should be subject to tax at a flat rate of 50 per cent.

b) The income of individuals and families should be subject to progressive rates of tax with a top marginal rate of 50 per cent.

c) The corporation should be allowed to allocate after-tax corporate income to shareholders without having to pay cash dividends.

d) The tax base of the resident shareholder should include the corporate income paid or allocated to him, grossed-up for the corporation tax paid.

e) The resident shareholder should receive credit against his personal tax liability for the full amount of the corporation tax on after-tax corporate income paid or allocated to him, with a refund of the corporation tax if the credit exceeded the liability.

f) Realized gains and losses on corporate shares should be included in income and taxed at full progressive rates.

g) The cost basis of shares should be increased when the corporation allocated retained corporate earnings to shareholders and thereby

created "allocated surplus", so that share gains resulting from the retention of earnings that had been taxed to the shareholder would not be taxed again to the shareholder when realized.

h) When dividends were paid out of allocated surplus they should not be included in the shareholder's income but should be deducted from his cost basis for the shares, because such dividends would represent a realization of funds already included in income and previously added to the cost basis of the shares.

i) A corporation with a small number of shareholders which met specified conditions should be entitled to elect to be taxed as a partnership in order to avoid the payment by the corporation of tax at 50 per cent and the claiming by the shareholders of refunds equal to the difference between that tax and tax calculated at their personal rates.

ADVANTAGES OF INTEGRATION

6. The integration system has the following advantages relative to the present system:

a) The system would neither encourage nor discourage the retention of earnings by corporations.

b) Corporate cash retentions could be increased without worsening the cash position of most shareholders.

c) To the extent that the tax reduction was not passed on in the form of lower selling prices or higher purchasing prices, after-tax corporate income from Canadian equities would be increased for most resident shareholders with the result that share prices would rise, the cost of equity capital would fall, and the rate

of capital formation by corporations would be increased until a new equilibrium was reached, that is, until rates of return declined toward their original levels.

d) Non-residents holding shares in Canadian corporations would be encouraged to sell them to Canadians, and Canadian corporations wholly owned by non-residents would be encouraged to raise capital by issuing equities in Canada.

e) Tax avoidance through surplus-stripping should no longer be a problem.

f) Tax avoidance through the creation of associated corporations to take advantage of the dual rate would be removed. This should not result in a worsening of the position of new and small businesses because we recommend a more effective incentive in Chapter 22.

g) The tax treatment of corporations, trusts, and mutual organizations including co-operatives would be put on a similar basis.

h) The allocation of resources would be improved with a resulting increase in the output of the goods and services that Canadians want.

i) All corporate source income would be taxed at progressive rates of tax.

DOUBLE TAXATION

7. The present tax system imposes double taxation on most corporate source income in the literal sense that income is taxed to the corporation and is often taxed again in the shareholder's hands when distributed, although the dividend credit of 20 per cent approximately offsets the corporation tax on small income corporations.

8. This does not mean that the present corporation income tax is wholly borne by current shareholders; indeed, the presumption is that it is not. Changes in the corporation income tax are, to some indeterminate extent, shifted almost immediately to suppliers and consumers through changes in the buying and selling prices of the goods and services bought and sold by corporations. To the extent that these price changes are made, the after-tax income of corporations remains unchanged. Where these price changes are not made, changes in the corporation income tax cause changes in expected after-tax rates of return that are capitalized in share prices.

When a tax increase is shifted, consumers and suppliers bear the burden of the tax through higher prices or lower costs; when the tax increase is not shifted, those who hold shares at the time of the tax change suffer capital losses. The converse holds when corporation income taxes are reduced. Increases in the corporation income tax have the effect of being partly a crude sales tax and partly a crude tax on one kind of wealth at one point in time. The greater the shifting, the greater the extent to which the corporation income tax is a crude sales tax, and vice versa. These effects are not confined to the corporation tax, since an increase or reduction in taxes on other organizations and individuals may also be shifted to an undetermined extent.

9. Changes in the corporation income tax cause changes in the allocation of resources. When the tax is shifted, relative prices are changed and this results in changes in the kind of goods and services bought by consumers and hence produced by labour, capital, and natural resources. When changes in the corporation tax are not shifted, expected after-tax rates of return are changed, and this results in changes in the relative rates of fixed capital formation among industries and among corporations within industries. Although there may be exceptions, the presumption is that, on balance, the imposition of a general

corporation income tax has an adverse effect on the allocation of resources. Fewer goods and services of the kinds that Canadians want are produced. This is the real burden of the tax today. The increase in future output is a major benefit that would result from its removal.

10. The results of the removal of the double tax on corporate source income through integration can be summarized as follows:

a) To some extent, the tax change would be shifted in the form of lower selling prices or higher purchase prices.

b) To the extent that the tax reduction was not shifted, shareholders at the time would make capital gains, since the anticipated after-tax earnings would be increased. The amount of these gains would be reduced by the proposed taxation of capital gains.

c) The size of the capital gains would depend on expectations about the speed with which the higher after-tax rate of return would be brought down through increased investment by competitors.

d) Where productive facilities were readily reproducible and where the degree of competition was great, the adjustment in the rate of investment would be more rapid, the after-tax rate of return would be reduced more quickly, and the initial capital gain from the removal of the double tax would be smaller.

11. While the primary purpose of eliminating the double tax on corporate source income is to secure a re-allocation of resources and an increase in output in the economy, it is important that this be done under a system which would secure neutrality and consistency of treatment for income derived through all kinds of organizations and from all forms of transaction. Apart from the other benefits this would produce, it should eliminate the problem of surplus-stripping and should substantially reduce opportunities for other forms of tax avoidance.

INTEGRATION AND CAPITAL GAINS

12. Introduction of full taxation of property gains would partially offset the favourable effects of integration so that the share gains from the adoption of integration would be substantially reduced relative to what they would be if integration alone was adopted. Some of our other proposed reforms, such as the removal of the special incentives for the resource industries, would also have a negative influence on share gains. To reduce the unwarranted windfall gain to current shareholders that would result from the adoption of our integration proposal, it would be imperative also to adopt full taxation of share gains.

COMMITTEE-OF-FOUR PROPOSAL

13. Under this proposal, all distributions would be subject to tax at a flat rate of 15 per cent; no further tax would be imposed on shareholders, but refunds would be allowed to low income shareholders. This proposal was carefully considered and rejected. Our fundamental objection is that it fails to apply the same progressive rates of tax to corporate source income as to other kinds of income. It would presumably be adopted in conjunction with concessionary rates of tax on share gains and with the maintenance of the dual rate of corporation tax. A system embodying this proposal would lack neutrality and would be about as inequitable as the present system. Most of the present problems would be perpetuated. If the proposal was combined with the taxation of share gains at concessionary rates, it would add some new complexities and avenues for avoidance.

OTHER ALTERNATIVES

14. A number of other alternative systems of taxing corporate source income were considered and rejected on the grounds discussed in the text, in Appendix F to this Volume and in supporting studies. We also considered

the methods of taxation of such income that are used in some other countries, and these are also discussed in the text and in Appendix G to this Volume.

TECHNICAL ASPECTS OF THE PROPOSAL

15. The corporation should be required to pay any additional taxes necessary to bring the total taxes paid or deemed to be paid on all distributions to 50 per cent, so that shareholders would always claim credit at that rate, and the complexities of the system would all be at the corporate level where they could be dealt with more readily.

16. A shareholder should acquire the right to a gross-up and credit for corporation income tax if a distribution or allocation was made by a corporation in any of the following ways:

a) cash dividend;

b) stock dividend;

c) capitalization of surplus without stock dividend; or

d) allocation of earned surplus without capitalization.

Corporate income allocated by any one of the last three methods would be added to the cost basis of the shares. An allocation under the fourth method would be made by the company for tax purposes only.

17. Foreign source direct investment income when earned (business income), or received (dividends), should be subject to an arbitrary rate of gross-up of 30 per cent for the foreign tax credit to be allowed. If this income was not subject to foreign income tax of at least 30 per cent at the time it was earned in the foreign jurisdiction, then a special Canadian tax equal to the deficiency should be paid at that time. Canadian corporations with foreign source direct investment

income should withhold an additional tax of 20 per cent on amounts distributed or allocated to Canadian resident shareholders in order to bring the total taxes paid on such distributions up to 50 per cent.

18. Losses realized by the corporation should not be allocated to shareholders, but should be carried back and forward in the manner described in Chapter 22. However, losses could be carried back and applied in the two preceding years only to the extent of the taxed income not previously distributed or allocated to shareholders. Losses at the corporate level that were reflected in reduced share prices could be deducted by the shareholders from other income, whether or not realized, through revaluation of their shares as proposed in Chapter 15.

19. Intercorporate dividends or allocations should be treated in the same way as dividends or allocations received by an individual with the full gross-up and credit. Corporations which incurred losses on their operations and which received dividends should be entitled to refunds as a result of the credit on the dividends received.

20. The personal corporation and investment corporation provisions of the present Act would be unnecessary. The provisions in the Act to counter avoidance of tax on corporate surplus could also be removed.

21. Life insurance companies and the trustees of Registered Retirement Income Plans should be entitled to the gross-up and credit with respect to dividends received, and would be entitled to a refund of the corporation tax paid where applicable.

22. Dividends on preferred shares should be treated on the same basis as common stock dividends.

23. Distributions or allocations under any of the above procedures should be treated as having been paid first out of income on which the corporation had paid tax or was deemed to have paid tax. Any distribution

in excess of the income which had been subject to corporation tax would be treated as a return of capital and would be applied to reduce the cost basis of the shares.

24. In future treaty negotiations, an attempt should be made to secure for stock dividends the same treatment as is now accorded ordinary dividends. In the meantime, the "allocation of surplus without capitalization of surplus" procedure would make it possible for foreign-controlled Canadian corporations to bestow the advantages of integration upon their Canadian shareholders without adverse tax consequences to themselves. In addition, some types of capitalization might be treated as not being subject to withholding tax.

25. The gross-up and credit to the shareholder should be made at the rate of tax applicable to corporate income in the year of distribution or allocation.

PARTNERSHIP OPTION

26. A corporation with a relatively small income and with a small number of shareholders should be entitled to be taxed as a partnership if it complied with certain conditions. This would avoid the necessity for payment of the corporation tax and the claiming of refunds. Each shareholder would include in his tax base his portion of the corporation's income. If the corporation had a loss, each shareholder could claim his portion of the loss as a deduction from other income, but the corporation could not then carry the loss back or forward.

SOME PROBLEMS IN THE PROPOSAL

27. To reduce tax avoidance, it would be imperative that top marginal personal income tax rates should not substantially exceed the corporate rate for protracted periods of time. This would create some rigidity in the system, but it would not be serious. Because of the tax credit

and refund procedure, the level of the corporate rate would not have as much significance under our proposal as it now has, and it would be possible to achieve the same or greater control over corporate investment without changes in the corporation tax rates.

28. The implications of our integration proposal for federal-provincial fiscal relations are discussed in Chapter 38.

29. Strict control should be imposed over the issuance of T5 slips by corporations.

30. Provisions should be introduced to preclude the postponement of allocations of profits which should be attributed to non-resident shareholders. This would be necessary to prevent the sale of shares by non-residents to residents who would obtain distributions or allocations of the tax-paid earnings, obtain the credit on such distributions or allocations and sell the shares at a loss that would offset the income.

31. To prevent the avoidance by non-residents of the full rate of corporation income tax, interest payments by a Canadian corporation to non-resident investors with whom it was not dealing at arm's length should be deemed to be dividends. They would therefore be non-deductible and should be subject to witholding tax at the rate applicable to dividends.

TRANSITIONAL PROVISIONS

32. It would be preferable to introduce all of the proposed changes, including full integration and the full taxation of capital gains, at one time rather than in stages over a period of years.

33. The surplus existing at the date on which the provisions became effective should be regarded as capitalized. Any distribution out of this surplus to a resident shareholder should be treated as a partial realization of the shares and should be applied in reducing the cost basis of the

shares. Distributions out of this surplus to non-residents should be subject to withholding tax in the same way as distributions to them out of any other surplus.

54. The revenue from the full taxation of share gains and from the elimination of most of the special corporation tax concessions would grow very slowly, while the revenue loss from integration would be immediate. If the economic conditions at the time the legislation was to be amended made it necessary to maintain the level of government revenues, two acceptable alternatives would be available to accomplish such an objective. The general level of tax on all income of resident individuals could be increased temporarily, or a special tax applicable only to corporate source income could be imposed for a transitional period. We favour the first approach, but in the event that the second alternative was chosen, we have outlined in Appendix J to this Volume the form that such a tax could take.

REFERENCES

1/ See, for example, Richard Goode, "Alternative Approaches to the Integration of Corporate and Individual Income Taxes", Proceedings of the National Tax Association, 1947, pp. 134-145.

2/ $$\text{Grossed-up corporate income} = \text{Distributed or allocated corporate income} \times \frac{100}{\text{100 minus the corporation income tax rate}}$$

3/ The lower federal rate of corporation income tax of 18 per cent plus 3 per cent old age security tax is discussed in detail in Chapter 22. We only note here that the determination of eligibility for, and the prevention of abuse of, the provision has been the source of endless difficulty in the fifteen years since the dual rate was introduced.

4/ In this chapter we use the terms "retention", "retained earnings", "surplus", "accumulated surplus", and "undistributed income" interchangeably.

5/ At the request of the Department of Finance, our staff prepared a study on surplus-stripping in the fall of 1963. The purpose of the study was to analyze this problem and to suggest solutions within the context of the existing tax system, that is, in the absence of a tax on capital gains. Although the study represented preliminary views of the staff that were subsequently modified substantially, and although it has only limited relevance in terms of the system we recommend, it is being published as a separate study without revision because we believe it provides a useful analysis of some basic weaknesses in the present tax system. In addition, Appendix D to this Volume contains a further discussion of this problem and the various legislative measures that have been implemented in an effort to eliminate surplus-stripping.

6/ Section 28(2).

7/ Section 105B.

8/ Section 105C.

9/ Section 68.

10/ An earlier Royal Commission considered this question. In suggesting a possible method of integrating the personal and corporation taxes the Rowell-Sirois Report of 1940 observed:

> "Investment income in the form of dividends is taxed twice while all other income (including investment income in the form of bond interest) is taxed once only."

Report of the Royal Commission on Dominion-Provincial Relations, Book II, Chapter VIII, p. 152.

11/ The change in the allocation of resources caused by the corporation tax may, as we have said, compensate for distortions resulting from external effects and market imperfections that would have existed in the absence of the tax. In these circumstances, the corporation income tax improves the allocation of resources. There is no presumption, however, that these nice compensations occur frequently; indeed, the presumption is that they much more frequently do not. In any event, the compensating adjustments should be made explicitly in most situations where they are required and should not be applied to all corporations. Corporations have nothing in common except the form of organization. General provisions in the tax system are a very inefficient way of solving specific resource allocation problems.

12/ This recovery in the prices of shares is analogous to the increase in the price of a discounted bond as the maturity date of the bond approaches. The original decline in price reflects the expectation of a less than market rate of return for a certain number of years, with the annual gain (or recovery) in price being in effect part of the yield—so that the gain in price plus the income from the asset equals the market rate of return. However, in the case of shares, both the length of the adjustment period and the magnitude of the adjustment

are uncertain so that this process of recovery would not be as smooth or predictable as is often the case for bonds.

13/ Even if it is assumed that aggregate rates of saving and risk preferences remain unchanged, other things are unlikely to be completely equal, because the riskiness of different industries may be changed as a result of the liquidity effects of a change in the unshifted portion of a corporation income tax. Moreover, all this is quite apart from other things which may change but which have nothing to do with the corporation income tax.

14/ Report to the Minister of Finance by the Special Committee on Corporate Taxation, March 21, 1961, published as "Special Report No. 8", Canadian Tax Reporter, Toronto: CCH Canadian Limited, 1963.

15/ For example, it is discussed briefly in the study on "Stripping of Corporate Surplus" published by the Commission. See also Appendix N to this Volume.

16/ The Committee stated that it adhered to the basic principle that the shareholder's tax should be fixed at a flat rate of 15 per cent. It stated, however, that if it was considered desirable as a matter of policy to modify the flat rate to introduce a limited degree of progressiveness, then shareholders with incomes above $10,000 could be taxed on their dividend income under a special schedule of maximum rates. These rates ranged from 15 per cent to 40 per cent. The Committee also said that "Even the above rates will invite, in some degree, resort to devices to avoid these taxes". "Special Report No. 8" op. cit. pp. 18-19. Because of the Committee's reluctance to apply progressive rates to the dividend income of shareholders with incomes of $10,000 or more, and because it was acknowledged that this approach would be subject to the abuses they sought to correct, we assume that the application of progressive rates was not part of their

major recommendation and do not discuss it further. A comparison of the taxes that would be paid on corporate source income under the Committee-of-Four proposal and under the system we recommend is presented in Appendix N to this Volume. This comparison is on the same basis as the comparison of our proposal with the present system given in Appendix M to this Volume discussed earlier.

17/ L. Fisher and J.H. Lorie, "Rates of Return on Investments in Common Stocks", Journal of Business, Vol. XXXVII, 1964. This subject is discussed further in Chapter 37.

18/ A "goodwill" capital gain is an increase in the value of the shares that is not a reflection of an increase in the tangible assets of the corporation, but rather reflects an intangible asset, that is, the premium the prospective shareholder is willing to pay for the anticipated earnings of the corporation.

19/ The United Kingdom Finance Act, 1965, which provides for a new corporation tax, nullifies any possibility of tax reduction by non-resident parent corporations through the use of intercorporate loans rather than equity capital to finance the operations of their British subsidiaries. It does so in two ways: first, by imposing a withholding tax on interest payments and, second, by prohibiting the deduction of interest by the subsidiaries in the computation of profit.

The interest payment, if it is a "distribution", is not deductible by the British company in computing its profit for corporation tax purposes (Finance Act, 1965, ss. 52(2) and 53(5)), and it is also subject to withholding tax at the standard rate of 41.25 per cent, unless modified by international tax agreement. In effect, therefore, such interest payments could bear an aggregate British tax of 64.75 per cent (corporation tax of 40 per cent and withholding tax of 41.25 per cent on distribution). This is the same as the rate applicable to dividends, unless altered by tax treaty.

The term "distribution" has been given an extremely wide meaning under Schedule 11 (section 47(5)) and includes any interest in relation to securities issued by a company to a company not resident in the United Kingdom, where the former is a subsidiary of the latter or both are subsidiaries of a third company (Schedule 11, 1(1)(d)(iv)). In this context, a "subsidiary" of another company means a body corporate of which not less than three quarters of its ordinary share capital is owned directly or indirectly by that other company (Finance Act, 1965, Schedule 11, 1(1)(d)(iv); Finance Act, 1938, Chapter 46, section 42(1)).

CHAPTER 20

MUTUAL ORGANIZATIONS AND TAX-EXEMPT ENTITIES

THE NATURE OF THE PROBLEM

We define the term "mutual organizations" broadly. While the term commonly is associated with co-operatives, credit unions, caisses populaires, and mutual insurance companies, we believe it is also applicable to such organizations as boards of trade, labour organizations, fraternal orders and private clubs, and to some aspects of charitable organizations. We also include incorporated and unincorporated bodies in this term, and our recommendations throughout this chapter are applicable to both types of bodies.

In the typical business operation four groups are involved: suppliers of goods and services that are used in the production of other goods and services sold by the business, suppliers of funds on a contractual basis, suppliers of funds on a residual-claimant basis and the buyers of the goods and services produced by the business. Each party pursues its own self-interest: the residual claimant, or the management that represents the residual claimant, strives to reduce costs and increase revenues; the suppliers of goods and services and contractual funds strive to increase the prices they charge the business; the customers try to obtain goods and services at the lowest possible prices. While it is by no means simple to determine the income of each party for tax purposes, as the discussion of business income in Chapter 22 demonstrates, usually one can at least begin with records of transactions based on prices that have been determined at arm's length. However, the primary characteristic of mutual organizations for tax purposes is that each member is usually a residual claimant against the organization and is also a supplier to the organization or a customer of the organization, or perhaps all three simultaneously. Accordingly, measurable economic gain does not emerge naturally and may not appear at all.

Although in practice the functions may be combined, it is useful for analytical purposes to distinguish three types of mutual organizations:

1. Those that market the stock-in-trade of their members.

2. Those that supply the members with goods and services that are used in the business operations of the members.

3. Those that supply their members (and sometimes non-members) with consumption goods and services.

Mutual organizations that perform functions 1 and 2 we shall designate as producer co-operatives; mutual organizations that perform function 3 we shall call consumer co-operatives. Many mutual organizations that are not usually considered to be consumer co-operatives, such as private clubs, have many of the same characteristics as consumer co-operatives. Thus, what we say about consumer co-operatives often applies to them too, as we shall show later.

Producer Co-operatives Performing a Marketing Function

Most producers of goods and services enter into a contractual relationship with those who buy their output. They receive cash or a contractual right in exchange for their goods and services. Members of marketing co-operatives, however, transfer goods and services to the co-operative in exchange for cash <u>and</u> a residual claim against the income of the organization. The form of the consideration, whether cash, contractual claim, or residual claim, is of no significance from the point of view of the comprehensive tax base, which should include all such elements.

If a co-operative's profits were distributed annually to satisfy the residual claims of its members, or if the change in each member's interest in the enterprise was valued each year, there would be little occasion to impose tax on the organization. But such is not the case, so it becomes necessary to tax the undistributed profits in the hands of the co-operative,

which otherwise could be accumulated in such a way as to defer the receipt of income by individuals.

Producer Co-operatives Performing a Supply Function

Two situations can be distinguished for co-operatives of this type:

1. Those in which members pay regular market prices for the production goods they buy and receive a residual claim against the income of the organization.

2. Those in which members buy production goods from the organization at less than market prices.

Because the costs incurred in buying production goods are deductible in computing the net gain of a member, no tax problem is created when the member buys his producer goods below regular market prices. His net gain will be larger and it will be taxed in his hands. When the member buys producer goods at market prices and acquires a residual claim against the income of the organization, his net gain from production would be understated if the value of the residual claim were ignored. As in the case of co-operatives that perform a marketing function, patronage dividends should therefore be added to the income of the members, and the income of the co-operative not distributed to members should be taxed at full rates to the organization.

Consumer Co-operatives

Consumer co-operatives have different tax implications from producer co-operatives because their products are mostly consumer goods, expenditures on which are not deductible from income for tax purposes for reason discussed in Chapter 8. If the members of consumer co-operatives can get more consumption goods for the same cash outlay, or the same consumption goods for a smaller cash outlay, relative to persons who are not members of the co-operatives, members would have greater economic power than non-members. In principle, this gain should be brought into the tax base of the members. However, the present tax system does not bring into income either patronage

dividends "in respect of consumer goods or services", or any benefits received through the acquisition of goods or services at less than their regular market price.

Other Forms of Mutual Organization

Most of the other forms of organization mentioned, such as caisses populaires and credit unions, private clubs, and labour and business non-profit organizations, are in effect mutual organizations that fall into classifications similar to those discussed for co-operatives. While private clubs and credit unions are similar to consumer co-operatives, labour or business organizations promote the interests of their members in much the same way as producer co-operatives. Thus, while private clubs and credit unions, to the extent that they reduce the cost of a service, provide a form of tax-exempt benefit to their members, labour and business organizations are primarily concerned with increasing the employment or business income of members, a form of income that is at present taxable.

Assessment of the Present Tax Treatment

In arriving at their taxable incomes, co-operatives are able to deduct all or most of their patronage dividends, which are taxable to the recipient (except in the case of consumer co-operatives). Only their unallocated income is subject to corporation income tax. This is in accordance with the principles we have enunciated. Nevertheless, co-operatives have had a distinct advantage over corporations, because the equivalent treatment of a corporation would be the allowance of the deduction of interest <u>and</u> dividends in the determination of income.

Adoption of our integration proposal would go a long way toward removing this disparity by bringing the treatment of corporations closer to the treatment that has heretofore been accorded co-operatives. By allowing a full credit for corporation income tax paid, the tax burden on shareholders would be the same as that accorded to members of co-operatives. This is eminently desirable. However, the payment of tax on corporate income before the deduction

of dividends reduces the cash available for retention by the corporation, and accordingly it would be necessary to establish rules requiring that a minimum proportion of the distributions of co-operatives be in cash, if co-operatives were not to have a cash flow advantage over corporations.

The non-profit organization performing functions similar to the co-operative has been in a better position to the extent that accumulated net income is not taxed at all. For many non-profit organizations the excess of income over expenditures would not be material.

Conceivably, a mutual organization could "price out", that is, eliminate any net earnings, by selling consumer goods and services at out-of-pocket cost on precisely the same terms to members and non-members alike. This would be most unlikely, however, if the operation of the organization required a significant investment by the members. If the organization were able to offer below-market prices to all and sundry, the business would presumably grow rapidly, and the organization would need more capital. The members would be unlikely to contribute more capital if the benefits of membership were also available to non-members. Accordingly, it would usually be necessary to retain earnings so that they could be ploughed back into the business. Indeed, if it were possible to ensure that mutual organizations always offered to members and non-members precisely the same goods and services at precisely the same terms, and informed members and non-members alike as to what was available, there would be little tax problem; for these organizations would be modest in size and the prices established would probably be close to market prices.

What is of concern is the situation where members invest in a mutual organization and secure a return on their investment by way of below-market prices for the consumer goods or services that they consume, or through a rebate on their consumption expenditures by means of a patronage dividend or similar distribution. Such gains may be attributable only to the main activity of the organization, that is, the activity for which the organization was formed, if all the capital is employed in that activity; or they may flow from an unrelated business or investment. An example of the latter is the use of dividend or interest income received by the organization to

reduce the selling prices of regular consumption goods and services (either directly or through patronage dividends). If all these gains are not included in income, an unfair tax advantage is conferred on the members of mutual organizations relative to other individuals who are taxed on the returns on their investments.

In summary then, the producer mutual organizations pose few problems in the reporting of the proper amount of income, but do involve some difficulties as to when income is reported. However, the need to prevent deferment of income taxes is not unique to this area. On the other hand, the consumer mutual organizations at present produce tax-free income for their members. Thus, the overall proposal for a comprehensive tax base, and our recommendations for the stricter taxation of employee and shareholder benefits, logically extend to encompass a more realistic approach to mutual organizations.

Section 75 of the present Income Tax Act partially limits these benefits available to members of a co-operative organization by restricting the deduction of patronage dividends so that:

1. The co-operative will have at least a 3 per cent return on the capital employed.

2. The dividends will not exceed that part of the income attributable to sales to members.

However, not only is the required minimum return much too low to eliminate the tax advantage, but these organizations are able to reduce the significance of the limitation on the deductibility of patronage dividends by conferring benefits on members, not by paying patronage dividends, but rather by making goods available to them at cost. In addition, it is possible to "price out", or eliminate, other forms of income received, such as interest, dividends and rent, by using such income to reduce prices to members. Another deficiency of the present system is that patronage dividends "in respect of consumer goods and services" are not included in the income of members. Furthermore, there is a wide variety of other mutual organizations which, in effect, perform

the same function as consumer co-operatives but are not brought under the statutory limitations we have just mentioned. We have in mind private clubs and non-profit organizations with substantial incomes from non-members that can use this income to subsidize the personal consumption of their members.

One "solution" to this problem would be to have the tax authorities revalue all transactions of mutual organizations and assess tax on the basis of what the gains would have been at fair market value. This would be hopelessly difficult. Another approach would be to require all mutual organizations to bring into their income <u>at least</u> an imputed return on all their assets. This income imputed to the organization would then be subject to the 50 per cent rate in its hands, unless allocated to the members, who would have to bring it into their taxable incomes. This has the great advantage of simplicity and enforceability. It might appear to be somewhat incongruous to impute income to a man with respect to his club but not with respect to the use of his own home or for some other personal arrangement. However, while an individual would ordinarily be confined to specific and isolated arrangements, a mutual organization provides a focal point through which many individuals can engage in a merging of income earning and personal expenditure activities, without having to make a number of separate arrangements. Moreover, when an organization is involved it may be possible to arrange that measurable income does not arise from transactions that would give rise to income if entered into directly by individuals. This would be the case, for example, if investment income of the organization was used to reduce prices of goods to members.

Proposed Solution

We suggest that, as a general rule and subject to our specific recommendations, the following features should be part of the taxation of income from mutual organizations (as defined):

1. <u>All</u> patronage dividends and similar distributions should be taxable to the individual; they should be subject to a 15 per cent withholding tax as discussed below.

2. Patronage dividends and similar distributions should be deductible by the organization to the extent that at least one half of the distribution was paid in cash. That is, in order that a patronage dividend of $100 would be deductible, $50 would have to be paid in cash.

3. Dealings with non-members should be deemed to be a separate business from dealings with members.

4. Losses originating from the provision of consumer goods and services to members of the organization should not be deductible from other income of the organization but should be eligible for carry-over against income from the same activity.

5. The unallocated income of mutual organizations should be taxed at the rate applicable to corporations.

The legislation should define the types of organizations that would be eligible for the above treatment. Because preferential tax treatment would be involved (at least in the case of consumers' organizations), the procedures for determining eligibility should be restrictive, and such eligibility should be subject to periodic review. The requirement for such review would involve better annual reporting and close scrutiny by the tax authorities. Just as we would allow a closely held company to elect to be taxed as a partnership, so we believe that a mutual organization should be given the option of being taxed either as a mutual organization or a corporation. This option would ensure that no mutual organization would be at a tax disadvantage relative to a corporation with which it competes. Such an election would mean application of the usual rules relating to benefits conferred on shareholders and members. These rules would not otherwise apply to benefits conferred by a mutual organization in the course of carrying on its principal activity.

The above approach continues to involve a concession to the members of consumers' mutual organizations, in that their tax bases would not include an amount for an imputed return on their assets used in conducting the principal activities of the organization (a concession that is similarly available to any

individual in respect of assets employed for personal consumption). However, it would prevent the deduction from other income of any losses realized on the disposition to members of consumer goods and services (a limitation that is similarly applicable to individuals with other losses and expenditures of a personal consumption nature). We have recommended this approach on the assumption that it would reduce the major tax advantages that would otherwise be available through use of a mutual organization. In addition, we have assumed that our recommendations would prevent mutual organizations from using substantial income from other businesses or from non-members to subsidize benefits to members. Unfortunately, as we show later, the rules necessary to prevent this latter abuse are complex. Should the complexities be overwhelming, or should avoidance or evasion prove to be substantial, it would be necessary to introduce a procedure for imputing a rate of investment return on the assets employed in the primary functions of the organization. Such an alternative appears to be the only practical way of taxing at least some of the indirect benefit flowing from a mutual organization. Certainly it would be more effective than attempting to limit the business done with non-members, and might be more practical than attempting to assess tax on business with non-members.

This procedure would involve taxing imputed income derived through these organizations, and so would be a departure from our general recommendation that, for administrative reasons, imputed income should be excluded from the tax base. However, in this case the inclusion need not be unduly complex. Once an appropriate rate for the deemed investment yield has been arrived at, the problem would be to determine the assets to which it should be applied. We assume that these assets would be valued at cost less an appropriate rate of amortization, or by some other procedure similar to those employed in determining the rate bases of regulated utilities. If the assets to be included were those defined in Chapter 22 as contributing, for tax purposes, to the future income of the business, the problem would be one of determining which business activity should be subject to the deemed investment yield.

Most securities and income-producing real property would be excluded, because the income therefrom would be taxed separately, but the assets employed in the primary functions of the mutual organization, such as buildings, furniture and fixtures, and inventory, would be included.

CO-OPERATIVES

In recent years the business operations of co-operative organizations have enjoyed rapid growth, and it is vigorously claimed by their competitors that the tax treatment of co-operatives has been a significant factor in their success. In this chapter we consider the nature of the co-operative organization in relation to income tax, and the appropriateness of present tax measures. No aspect of taxation was more fully dealt with in the public hearings before the Commission, and we are grateful to the participants for their full expression of all points of view.

The Co-operative Form of Organization

Originally, co-operatives arose to meet a pressing social and economic need in areas where the ordinary working of the market was not producing acceptable results. From somewhat limited origins, however, co-operatives have grown to fill a relatively small but vital part in the economic life of Canada, and many have taken on the characteristics of complex business enterprises. Although limited largely to certain areas of Canada and to certain industries, there is nevertheless no doubt that co-operatives have become firmly established in the economy.

There are many types of co-operatives, and in a short space all that can be done is to indicate their principal characteristics. Co-operatives have the stated objective of providing goods and services to their members at cost. This is generally achieved by pricing the goods and services initially at something near market, and later distributing any resulting surplus among the members as a patronage dividend in proportion to their business with the co-operative, frequently as a credit to members' accounts rather than in cash. Co-operative organizations are usually incorporated

by provincial statute and, therefore, like all corporations, are separate legal entities. Unlike the ordinary corporation, however, the customers or the suppliers of the co-operative are usually its owners. The authorized capital is usually small, and the main sources of funds are the patronage dividends left in the co-operative and loans from the members 1/.

Applicability of an Income Tax

In the representations made to the Commission, strong opinions were expressed on three basic questions. Does a co-operative activity create income? If so, how is it measured? Is it income of the co-operative, of the members, or of both? These questions are discussed below.

With respect to the creation of income, it was contended by many that, because the co-operative was intended only to provide goods and services to the members at cost, rather than to produce a profit, any surplus resulting from its operations was merely an adjustment in arriving at this fundamental objective and was not income as such. In other words, the co-operative was organized to carry out specific activities on behalf of its members, and any margin resulting from its operations was merely a saving for its members for whom it was acting as an agent. On the other hand, it was argued that co-operatives carry on business in the same fashion as business organizations and that their motive is economic gain.

In our view, the important point is that, if the economic position of the members is improved as a result of the activity, the economic gain is a proper subject for taxation.

There are problems in the measurement of that economic gain, however. As we have said, the co-operative is unlike an ordinary business enterprise. The owners in this case are usually the customers (or suppliers) and accordingly are indifferent as to whether income, or economic reward, arising from the operations is distributed in the form of price reductions or rebates or patronage dividends. Thus, while theoretically there is a return on capital and managerial ability, it cannot be said with exactness how great it is.

On the other hand, the stated general policy of most co-operatives is to follow market prices where they are determinable, and to avoid price wars and the danger of forecasting their margins incorrectly. Any major attempt to adjust prices to produce a break-even result at the end of the year, generally referred to as "pricing out", could affect their financial stability. When a co-operative prices its goods and services according to the market, the surplus it reports before distributing patronage dividends should represent a reasonable measurement of the income produced in the operation.

The stated policy of most co-operatives of following market prices does not ensure that pricing out will never occur. Moreover, some goods and services will have no generally established market price. Because pricing out can effectively be employed to distribute income by reducing the cost of goods and services, so that income does not emerge in the normal course, special provisions are necessary if such income is to be taxed.

There remains the question of whether the income is income of the co-operative, of the members, or of both. Many representatives of the co-operatives contended that it was basically income of the members, since the co-operative was acting as their agent for specific purposes, and the members could share in the income of the co-operative only if they did business with it. They further contended that this was supported by the allocation of patronage dividends to members according to volume of business, and by the fact that most provincial legislation requires substantial distribution of surplus earnings. On the other hand, it was contended by others that co-operatives, when incorporated, have a separate legal entity and separate management, so that in many cases they are virtually indistinguishable from ordinary business corporations, and that as co-operatives have become larger they have lost contact with the members despite the rule of "one member one vote".

Because of the present tax treatment of ordinary corporations, the question of whether income of a co-operative activity is to be regarded as income of the co-operative organization itself or of the members is extremely

important. However, under our proposed tax system, all income flows would be taxed in the same manner regardless of whether they came through partnerships, ordinary corporations, or other organizations; and the question of how much income was income of the organization would be of minor importance. In our view, the income of the co-operative should ultimately be taxed at the individual rates of the members in the same manner as the income of ordinary corporations should ultimately be taxed at the individual rates of the corporate shareholders. Admittedly, this objective is easier to achieve in the case of co-operatives than in ordinary corporations, because a high proportion of a co-operative's income is already allocated to members. Furthermore, the equity of a member in a co-operative is not marketable, so that no adjustment has to be made for a different value which he might achieve on the market. Despite this greater simplicity in the case of co-operatives, we can see no good reason for a material difference in the tax treatment of the two forms of organization.

History of Tax Treatment

Under the Income War Tax Act of 1917, there was a general provision that mutual corporations without share capital were not taxable, but the position of co-operatives was not clearly stated and they were generally disregarded by the taxing authorities. Where they were assessed, patronage dividends were deductible in arriving at taxable income. In 1930, a section was inserted in the Act to exempt co-operatives provided they met certain requirements. However, during the 1930's and the early war years, co-operative operations were extended to include manufacturing, processing, wholesaling, etc., and groups of related co-operatives were formed. In 1944, the government appointed a Royal Commission to review the tax treatment of co-operatives. The main findings of this Royal Commission were that the co-operative association and its members did make a profit as a result of their trading ventures, and that to the extent the profit was made readily available to members or customers it should be considered income of the members or customers and not of the association.

Under the legislative changes made in 1946, which remain in effect to the present time, the tax exemption for co-operatives was removed, and they became subject to tax upon their income generally in the same manner as other corporations. At the same time, however, a section was introduced permitting a deduction of patronage dividends in computing income 2/. Although this provision was not restricted to co-operatives, it was useful only to a co-operative operation where there was a common interest between the customer (or supplier) and owner of the business. Limitations were imposed on the deduction of patronage dividends to the effect that they could not be used to reduce the taxable income of the co-operative below 3 per cent of employed capital, 3/ nor to deduct on distribution to members the profits on business with non-members 4/. In addition, a provision was added to give new co-operatives a three-year exemption from income tax 5/. From the standpoint of the individual member, patronage dividends were to be reported as income, or as a reduction in cost of goods or services, if they related to his income from a business or property. Patronage dividends relating to goods or services for personal consumption were not required to be included in income.

Analysis of Tax Treatment

The imposition of tax on the income of co-operatives in 1946 was a recognition of the main conclusions of the Royal Commission on Co-operatives, and represented a considerable step forward in the tax treatment of this form of organization. Given the general system of taxing corporations, the 3 per cent minimum limit beyond which patronage dividends could not reduce taxable income was an attempt to prevent co-operatives from entirely avoiding the tax treatment applied to ordinary corporations. The three-year exemption of new co-operatives was originally given to help them get started. The reason for the exemption of consumer patronage dividends is not clear, but presumably it was based on the theory that such dividends merely represent a reduction in a consumer expenditure.

Since 1946, co-operatives have continued to grow, and their corporate competitors have contended that this growth was attributable to the ability of co-operatives to retain tax-free funds for expansion, mainly because the corporation income tax is not applied to income that is allocated to members but not paid out in cash.

The importance of the difference in tax treatment may have been overemphasized. Any adequate explanation of the growth of co-operatives must take into account broad social, political and economic factors. Furthermore, with respect to the tax factor itself, it may be noted that in the case of smaller corporate operations the combination of the lower rate of corporation income tax and the dividend tax credit has meant that the level of taxation on income flowing through an ordinary small income corporation has been close to that on income flowing through a co-operative; any remaining tax differential then mainly rests, as it should, in differences between the tax brackets of the members and the shareholders. The acceptance by members of co-operatives of non-cash distributions is probably due to the fact that this is a condition of membership in the co-operative, and therefore arises more from the nature of the organization than from the tax system. On the other hand, there is no doubt that, where there are large scale operations, the ordinary corporation is at a significant disadvantage because of the immediate withdrawal by the government of one half of the income before any distributions to shareholders, and the higher level of overall taxation imposed in respect of the distributed portion.

If the present basic method of taxing corporate income were to continue, it would be difficult to reduce substantially the difference between the taxation of corporations and co-operatives. Moreover, even if co-operatives could be effectively taxed in the same way as ordinary corporations, this would extend to co-operatives the serious inequities of corporate taxation which we have already discussed in Chapter 19. It does not seem to us that a requirement that patronage dividends be deducted only when paid in cash, as suggested by some participants, would equalize the situation or be entirely

effective, because members of a co-operative could hardly be prevented from lending cash distributions back to the co-operative.

Under our proposed method of taxing corporate income, the taxation of ordinary corporations would be much closer to the present method of taxing co-operatives, for the end result in each case would be taxation of distributed income at the personal income tax rates of the owners. However, there would still remain a difference in the cash flow of the entities themselves, arising from the difference in the method of integration. For the ordinary corporation, a corporate rate of tax would be applied to all the income of the corporation, with credit for that tax being given to the shareholders in respect of distributions. In the case of the co-operative, the corporate rate of tax would apply only to the income not allocated among members. A withholding tax levied at the co-operative source on all patronage dividends allocated or paid to members, with credit therefor being claimable by members, would serve both to reduce this difference (or eliminate it, if the withholding rate were 50 per cent) and, as with distributions by ordinary corporations, would facilitate administration.

Proposed Treatment

We have already listed our recommendations with respect to all mutual organizations, including co-operatives, but we think it would be helpful at this point to indicate in tabular form a comparison between a corporation and a co-operative, showing the similarity of result of our proposals. It is important that the co-operative form of business organization should be in exactly the same cash position as the corporation. As indicated in Table 20-1, if patronage dividends were deductible only to the extent that they were at least 50 per cent paid out in cash, this requirement would appear to be met.

We appreciate that there would have to be detailed regulations concerning the kinds of transactions that would be deemed to be cash distributions in order to qualify for the deduction (in particular, requiring that the

TABLE 20-1

AN EXAMPLE OF THE RECOMMENDED TAX TREATMENT OF INCOME FLOWING THROUGH A CORPORATION AND A CO-OPERATIVE

	Corporation $	Co-operative $
Profit before tax	100	100
Assuming that the organization is to retain no cash		
Distribution:		
In cash	50	100
By attribution (or grossing-up)	50	-
	100	100
At the organization level:		
Taxable income	100	-
Tax payable	50	15 a/
Cash retained	-	-
At the shareholder or member level:		
Taxable income	100	100
Tax payable or (refundable) net of withholding tax, assuming the individual is subject to a 30 per cent rate	(20)	15
Cash distribution received	50	85
Total cash after tax	70	70
Assuming that the organization is to retain $50 of cash		
Distribution:		
In cash	-	50
By attribution	100	50
	100	100
At the organization level:		
Taxable income	100	-
Tax payable	50	15 a/
Cash retained	50	50
At the shareholder or member level:		
Taxable income	100	100
Tax payable or (refundable) net of withholding tax, assuming the individual is subject to a 30 per cent rate	(20)	15
Cash distribution received	-	35
Total cash after tax	20	20

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a/ Withholding tax at 15 per cent. This would be calculated on the full amount of patronage dividends and deducted from the cash portion, as discussed in the text.

payment must be unconditional), but nevertheless we feel that such an approach could be administered. The other limitations at present applicable to the deductibility of patronage dividends should be removed, because they would be inconsistent with our proposal that the income flowing through the organization should be fully integrated at the time of distribution with that of the owners.

Any economic gain resulting from a co-operative activity is a proper subject for taxation. The amount of such economic gain is difficult to measure, but when the co-operative follows market prices the income before patronage dividends should represent a reasonable approximation of economic gain. When such a pricing policy is not followed, it is difficult to arrive at such an approximation. When the operations relate to business activities of the members, the income will be reported in any case as a reduction of business expense, or as an increase in revenue. Where the co-operative activity relates to personal goods or services, the patronage dividend should be taken as a measure of economic gain, and should be reported as income by the member.

Patronage dividends should continue to be deductible, but only to the extent that half of the dividends in any fiscal period had been paid unconditionally in cash. This means that a co-operative could declare all of its income by way of patronage dividends and pay out one half of this amount in cash. The other half would be retained by the co-operative but it would pay no tax, because the patronage dividends, which would be taxable to the members, would fully offset its income. This requirement would mean that the cash flow of the ordinary corporation would be the same as that of a co-operative. Thus, while the corporation would pay half of its profit in the form of tax, the co-operative would pay half of its profits either in taxes or in a cash distribution to members.

The recommended procedure still provides the member of the co-operative with some slight advantage as to the time of payment, since he would pay out

only the tax for which he was liable, while the shareholder in effect has 50 per cent paid on his behalf and must then wait for a refund of any credit due. For administrative reasons a withholding tax of, say, 15 per cent should be imposed on all patronage dividends. This would be calculated on the total patronage dividend, including both the cash and the non-cash portions, and would be deducted from the portion payable in cash. This should improve taxpayer compliance and would reduce the difference in the impact of taxation on funds immediately available to members and shareholders of co-operatives and corporations respectively.

We also recommend that the three-year exemption for new co-operatives should be discontinued. Of course, the special provision proposed for new and small businesses generally that is discussed in Chapter 22, would be applicable to new co-operatives.

In addition, it is necessary to prevent property income and business income from activities that are unrelated to the primary function from being, in effect, passed out tax free to members. Elsewhere in the Report we have emphasized the necessity of taxing, whenever practical, personal benefits provided to the owners of a business. In the case of co-operatives these benefits can take the form of price reductions on consumer goods and services. While we do not recommend a procedure of pricing all transactions at market prices, as is done in the case of the transactions not at arm's length of ordinary corporations, we feel that profits from unrelated activities should not be used to reduce the cost of goods and services consumed by members. For this purpose, business conducted with non-members of the co-operative is an activity unrelated to the major function of the co-operative, as is the earning of interest, dividends, and rental income. To prevent the application of such income to reduce the personal expenditure of members, it should be provided that any losses arising from the business activity of providing consumer goods and services to members of a co-operative should not be deductible from any other income of the co-operative and should only be eligible to be carried back two years and forward indefinitely

as a deduction from income derived from the same activity. This treatment is consistent with that proposed for other business "losses" that are considered to be in fact personal expenditures.

As has already been discussed, it might become necessary to also include in taxable income a deemed rate of return on the assets employed in the primary functions of co-operatives which provide consumer goods and services. Although such a procedure might be required to reduce the use of mutual organizations as tax-saving devices, we do not recommend the immediate introduction of such an imputed income measure.

If the value of a member's interest in a co-operative declined below his cost basis, except to the extent that the decline had resulted from losses in providing consumer goods and services to members, the member should be permitted to revalue his shares downward, and to claim a deduction for any resulting loss.

There should be no special problems in regard to any balance of undistributed income on hand as at the transition date. This income would generally have already borne tax at the corporation income tax rate, and therefore if distributed should be treated in the same manner as is recommended for corporations in Chapter 19.

CREDIT UNIONS AND CAISSES POPULAIRES

Credit unions and caisses populaires form another type of co-operative organization that has enjoyed rapid growth in recent years. Their income is exempt from tax 6/. These organizations now have an important role in the Canadian financial system. Some corporate competitors question the tax exemption afforded the credit unions and caisses populaires on the grounds that the function of many has become indistinguishable from that of other financial enterprises.

Form of Organization and Operation

Basically, a credit union or caisse populaire is formed as a separate legal entity under provincial law by a group of individuals having some common bond, such as employment, nationality, religion, or location of residence.

The primary business activity consists of receiving money from and lending money to its members and, if the growth of the organization permits, its activities may be extended to other types of banking services, such as chequing accounts and safety deposit box rentals 7/. An individual who comes within the common bond can usually become a member by acquiring one share at a cost of $5. Members are entitled to one vote regardless of the number of shares held or the amount deposited. Usually a limited rate of interest (or dividends) ranging from 3 per cent to 5 per cent is paid to members on funds obtained from their shares and deposits 8/. The interest charged on loans to members usually ranges from 6 per cent to 12 per cent with interest rebates made in some cases on a patronage basis. There is no stated policy of following the interest rates currently charged by other money-lending institutions.

The gross revenue of these organizations consists substantially of interest charged on loans to their members. The rate of interest paid on funds borrowed from members is usually at a predetermined rate based on the past experience of the organization. After the deduction of this interest, operating expenses and certain statutory reserves, some income may be allocated at the discretion of management to reserves for educational purposes, or for specific purposes such as a building. At this point, patronage dividends or rebates to borrowers are considered if it is the policy of the organization to make such adjustments; many do not, and merely reduce future interest charges where surplus earnings permit. Rarely, if ever, are retroactive adjustments made in the interest payable to depositors.

Representatives of the credit unions and caisses populaires defend the present tax exemption by emphasizing the desirable social effects of these organizations which promote thrift and self-help, combat high interest rates by co-operative action, and provide readily obtainable credit. They contend that no true profit exists because the organizations merely provide members with a service at cost; moreover, any technical profit that might be considered taxable could easily be eliminated by pricing out.

Applicability of an Income Tax

Largely because of the social effects stated above, the Royal Commission on Co-operatives recommended in 1945 that credit unions and caisses populaires be exempt from income tax. For tax purposes, however, we believe that the main consideration is whether a measurable economic gain results from the activity. If it does, there is an appropriate basis for taxation. Furthermore, the position of the credit unions and caisses populaires has substantially changed in the last twenty years; they have grown considerably in size and have become much more professional and competitive in their activities.

We do not doubt that members of credit unions and caisses populaires benefit economically from participation in these organizations 9/. The borrowing member may pay less interest in dealing with a credit union or caisse populaire than with some other financial organization, but as long as individuals generally are not required to include in their tax base an amount of imputed income for interest forgone because of investment in personal property, we see no justification for imputing income to the borrowing member of a credit union or caisse populaire 10/. Although the members are borrowing from a co-operative form of organization, the mutuality of interest between borrowing members and lending members is not readily apparent. While as members they all share in ownership of the organization, the conflict of economic interest between lenders and borrowers should give reasonable assurance against artificially low interest rates. The economic gain to the lender would appear to be the interest paid or credited on his shares or deposits; because the borrower is a mutual organization, the interest is in excess of what he could earn elsewhere does not matter, because it all represents taxable income in any event.

The portion of the economic gain retained by a credit union or caisse populaire as surplus earnings could be measured by the ordinary rules for determining business income as set out in Chapter 22. This procedure would probably result in the disallowance of some of the reserves at present recorded in the accounts of these organizations and, it might be contended,

would threaten their financial stability and encourage pricing out. However, it is their ability to accumulate tax-free income that is the most significant tax factor in giving them a competitive advantage. If the credit unions or caisses populaires wished to do so, they could pass out more of their surplus earnings to members in non-cash form, and thereby reduce the impact of the corporation income tax and yet retain financial stability. However, for the reasons already outlined in our discussion of co-operatives, it would be necessary to require that dividends paid or credited to members by a credit union or caisse populaire be deductible only to the extent that half of them were paid out in cash.

Proposed Treatment

Credit unions, caisses populaires and their members should be treated for tax purposes in a manner similar to that proposed for co-operatives and their members, which in turn is generally similar to that proposed for other forms of business organization.

All credit unions and caisses populaires should file returns of income. Their income should be measured under the ordinary rules for measuring business income and, to the extent that it was retained in the organization, should be subjected to the general rate of corporation income tax. Interest and dividends paid or credited to members, and interest rebates made on a patronage basis, should be deductible, but only to the extent that half of such amounts had been paid unconditionally in cash. As in the case of co-operatives, there should be regulations defining what types of payments would and would not be deemed to be cash disbursements. Thus, the cash flow of the credit union or caisse populaire would be affected by the tax system in the same way as that of the ordinary corporation.

Interest paid or credited on shares and deposits, and interest rebates made on a patronage basis, should be treated as taxable income in the hands of recipients, and should be subject to the same withholding tax of 15 per cent that we recommend for the patronage dividends of co-operatives.

In addition, a similar provision to that recommended for co-operatives should apply to the property income and the business income from activities that are unrelated to the primary functions of these organizations. In this case, the interest received on loans to members, less an appropriate part of interest paid and overhead costs, should be considered to be the income of a business separate from the other activities of the organization. Because this business provides a consumption service to members, any losses should be regarded as personal expenditures, and therefore should not be deductible from other income and should only be eligible to be carried back two years and forward indefinitely as a deduction from income derived from the business of making loans to members. This treatment is consistent with that proposed for other business losses, including those of co-operatives. Again it might be necessary at some future time to include in this computation a form of imputed income on certain assets employed in the business.

Because the undistributed income accumulated to the transition date in the credit union or caisse populaire would not have borne any income tax, and because distributions from these accumulations would, as at present, be subject to tax, it might be necessary to specify some order of distribution for interest and dividends paid. Consistent with our recommendations with respect to corporations, it would seem appropriate that future distributions to members should be regarded as having been paid first from current income, then from surplus accumulated subsequent to the transition date, and then from the opening surplus.

MUTUAL INSURANCE COMPANIES

Our recommendations concerning the mutual aspects of life insurance are included in other chapters of this Report: the measurement of the business income of a life insurance company in Chapter 24 and the treatment of the policyholder, for premiums and policy proceeds, in Chapter 16. Consistent with our approach to co-operatives, we recommend that allocations to policyholders in the form of policy dividends should be deducted in

arriving at the income of the life insurance company, whether stock company or mutual, and should be subject to a 15 per cent withholding tax. However, we do not think that a minimum cash payment would be necessary in the case of life insurance policy dividends, because the competitive situation is not similar to that existing for co-operatives, and because the cash retained from this source by the companies is not an important factor in the provision of capital funds for the operation. We also recommend that policy dividends should be taxed in full in the hands of the policyholders.

As we indicate in detail in Chapter 25, mutual general insurance companies follow such varying practices in setting premiums and paying policy dividends that it is difficult to establish a true measurement of the economic gain arising from the operation. Nevertheless, consistent with the tax treatment proposed for co-operatives, policy dividends should be deductible by the company, and includible in the income of the policyholder. Where the insurance coverage is of a business nature, the tax consequences of allowing the full premium as an expense and taxing the policy dividend as income would be equivalent to allowance of the net amount as an expense. Where the insurance coverage is of a personal nature, for example, on a residence or personal automobile, the tax treatment would differ from that at present in effect, but premium rates on participating policies would doubtless be revised to reflect more closely the actual costs, and as a consequence policy dividends would reflect more closely the actual gain from participation. Any unallocated earnings retained in the mutual insurance company should continue to be subject to the corporation income tax.

MISCELLANEOUS TAX-EXEMPT ORGANIZATIONS

The list of organizations or trusts, the income of which is specifically exempted from tax, has increased over the years and is now fairly extensive 11/. Several of these are discussed elsewhere 12/. The remainder will be dealt with below.

The income of some of these organizations is unconditionally exempt from tax. Several are exempt only if no part of the income was payable to, or was otherwise available for the personal benefit of, any proprietor, member or shareholder. Others are exempt only if they comply with certain statutory conditions. In no case is there exemption for only part of the income; if the organization meets the conditions for exemption, all its income is immune from taxation. Conversely, it would appear that if an organization does not meet the conditions for exemption, all of its income, however measured, is subject to tax.

Our general approach to such organizations (with the exception of governmental organizations) is that they should be exempt from tax only in so far as their primary functions are concerned.

Filing of Income Returns

An organization that is tax-exempt is ordinarily neither required to file a tax return nor is it subjected to tax audit. Therefore, at present there is little information available as to the flow of income through such organizations.

We recommend that all organizations, whether or not they claim exemption and whether or not they have taxable income, should be required to file returns of income. This would enable the tax authorities to audit the returns, to check on donations claimed where applicable, to ascertain whether receipts and benefits from tax-exempt organizations are being reported for tax purposes, and to judge the nature and scope of the operations that they carry on.

Governmental Organizations
(Including Public Utilities)

The Income Tax Act exempts from tax: municipalities and municipal or public bodies performing functions of government 13/; and corporations, commissions and associations not less than 90 per cent of the shares or capital of which is owned by Her Majesty in right of Canada or by a province

or by a municipality, and wholly owned subsidiaries thereof 14/. A limited number of Crown corporations are, however, denied an exemption by the Act and other federal legislation 15/.

Where strictly governmental functions are performed, we do not see a case for taxation of income, nor do we see a valid distinction between functions performed by government itself and those performed by separate entities formed by government for the purpose.

However, where government undertakes activities which compete with those of private business, the exemption of government instrumentalities from tax to which their privately owned competitors are subject, provides the former with an advantage to which the latter may quite reasonably object. There are many examples of government-owned corporations which compete with privately owned companies. For example, Canadian National Railways and Canadian National Telegraphs compete with Canadian Pacific Railways and Canadian Pacific Telegraphs respectively. Canadian National hotels compete with other hotels. Hydro authorities owned by provincial governments compete with privately owned suppliers of gas and oil for use in the home and in industry. The list could be extended.

As is indicated above, some corporations which are owned by the Canadian government are subject to income tax. These probably include most Crown corporations which compete with private industry. This treatment should be continued and the list should be reviewed from time to time to ensure that those federally owned companies which compete with privately owned corporations are subject to income tax.

It is well established that the federal government has no power to impose taxation upon a provincial government and that no province has power to impose taxation on the Canadian government or on the government of another province 16/. The restriction on taxation of another government extends to any corporation which is an agency or emanation of that government. Whether any particular corporation owned by a government is an agency or emanation

of that government is a question of fact and of interpretation in each case. There is, of course, nothing to prevent the Canadian government from taxing its own Crown corporations, and there would be nothing to prevent the Canadian government from taxing any corporation owned by a province, if the province waived its exemption and agreed to such taxation. From a practical standpoint, there would be difficulties in imposing taxation on a provincially owned corporation if agreement of the province was not obtained. Because of the constitutional problem and considerations of federal-provincial relations, we do not recommend that such corporations should be taxed unless the provinces agree to such taxation.

The Canadian government has made no attempt to impose income tax on any corporation which is owned by a provincial government or a municipality. On the other hand, Ontario legislation provides for the imposition of corporation income tax on certain corporations owned by the Canadian government 17/.

We suggest that, where governments or non-taxable government bodies are shareholders (with less than a 90 per cent interest) of companies which are subject to tax, they should be denied the right to the normal tax credit on distributions on such shares. There would be no practical way in which such credits could be integrated in the final analysis with the taxation of the individuals benefiting from the corporate source income. There probably would have to be provisions in the legislation to ensure that such credit is not obtained indirectly.

Privately Owned Public Utilities

Government-owned public utilities are exempt from tax under section 62(1)(c), while privately owned utilities are taxable. We have already emphasized the competitive inequality created by this type of provision. We point out, however, that the reduction of tax on corporate source income under our proposals, by reason of the integration of the personal and corporation income tax would substantially narrow the tax disparity between the two types of organization.

Representatives of privately owned utilities who appeared before this Commission contended that the exemption from income tax of government-owned utilities resulted in serious discrimination. They pointed to the heavy element of income tax in the sales dollar of a utility as compared to industry generally (15 per cent to 20 per cent as compared with 3 per cent to 5 per cent), and suggested an end-use tax on all electricity or gas instead of the present income tax.

The significance of the tax factor in this realm has been emphasized in recent years by provincial take-overs of privately owned hydro utilities, and suggestions that further take-overs might take place. Such take-overs have supposedly been encouraged by the fact that the portion of corporation tax revenue at present going to the federal government could be retained by the province for its own purposes, or used to reduce rates to hydro consumers.

The rate of federal corporation income tax on privately owned utilities which supply electricity, gas and steam in Canada is slightly less than that for industry generally. This rate is 45 per cent, or two percentage points less than the general rate of 47 per cent on income in excess of $35,000 18/ (excluding in both cases the 3 per cent old age security tax); and one half of the federal tax revenue so produced is at present returned to the provinces. Despite these modifications there is still pressure to return all the revenue from these public utilities to the provinces.

Some time ago, the federal government announced its willingness to pay to the provinces 95 per cent of the corporation income tax levied on these utilities (excluding the old age security tax). Federal authorities expressed the hope that the provincial authorities would transfer or credit the amount of this payment to the utilities so that it could be passed on by them to consumers, placing publicly owned and shareholder-owned utilities on a more equal footing. Since that conference, Parliament has passed the Public Utilities Income Tax Transfer Act, which authorized the Minister of Finance to pay to a province up to 95 per cent of the income tax paid by a designated corporation which is attributable

to gross revenue from the sale of electrical energy, steam or gas, after January 1, 1966. That Act also provides that, if a province pays or credits to a utility corporation any amount received from the federal government, the amount will be exempt from income tax.

Later we recommend that the federal government should consider arranging a transfer of revenue sources by which the federal government alone would levy all corporation income taxes, and the federal government would provide the full credits for corporation income tax. The corporation tax would become a method of collecting tax from shareholders rather than a tax on the corporation *per se*. Consistent with these other recommendations, we also recommend that the rate of tax on privately owned utilities should be the same as on other corporations. We appreciate that this might place such utilities at a disadvantage in competing with publicly owned utilities, but this seems unavoidable. If the federal government turns over to the provinces 95 per cent of the corporation income tax imposed on such utilities, under our proposals this would represent moneys which had also been credited by the federal government to resident shareholders. However, we make no recommendation with respect to this payment since it is outside our terms of reference.

Charities and Other Non-Profit Organizations

Under this heading we deal with a number of organizations at present exempted from tax by section 62 of the Act, and not already discussed in this chapter. Thus, we intend to discuss the tax treatment of charitable organizations, agricultural organizations, boards of trade, chambers of commerce, certain housing corporations, the Canadian Universities Foundation, non-profit corporations for scientific research, labour organizations, and non-profit organizations exempted under section 62(1)(i).

The characteristics of these organizations vary greatly, and there is no consistent single rationale that would support the complete tax exemption accorded to all of them. In fact, organizations have been extended exempt

status over the years without the establishment of any clear principles as to why such exemption should be granted and who should receive it. For the purpose of determining the most appropriate tax treatment that should apply, it is necessary first to establish the justification for extending special treatment, and then to assess whether the present tax treatment appears to meet the objectives satisfactorily. The organizations being discussed can logically be divided into three general groups.

The first group consists of charitable organizations as now defined in the Act, although with some modifications as discussed later, and so includes non-profit organizations that have been formed to pursue some general public purpose. Such organizations are not intended to provide any benefit to the contributor members, other than the better organization of the disbursement of their contributions to charity. The mutuality of interest exists more as a matter of convenience in organizing charitable endeavours than as a means of obtaining more direct benefits. If the organization does in fact meet the requirement of having a charitable purpose, there is some justification on social grounds for special tax consideration. However, if the purpose of the organization is to manage charitable endeavours, it would be reasonable to expect that the organization would not be actively engaged in a business.

The second group includes those organizations that are similar to the mutual organizations discussed earlier in the chapter. They exist primarily for the benefit of their members and are essentially of a private character. Their objectives are probably close to those of the consumer co-operative, in that the organization has usually been formed in order to provide personal goods and services to the members. Therefore, the element of personal benefit exists, for the goods or services are usually items of personal expenditure, and in many cases may be provided at a lower cost than would otherwise be paid. Examples of the type of organization that would be included in this group are those private clubs and societies that are formed essentially to provide social or recreational services or facilities for their members.

Certain other non-profit organizations fall in this group because they provide benefits for their members and do not qualify under the specifications of the other two groups. One example is fraternal benefit societies. Organizations in this second group do not appear to warrant any special tax consideration, because they exist to benefit individual members. To the extent that charitable goals are pursued, it should be possible to divide the activities of the organization into their separate functions so that the appropriate tax treatment could be applied to each.

The third group consists of organizations that do not fall in either of the first two groups. Examples of this type of organization are the trade, professional and union associations that, in general, attempt to better the position of their members in a fashion that would increase their taxable incomes. For tax purposes, the outstanding characteristic of this group is that, to the extent that the activities of the organization provide some benefit to the members, the benefit is generally reflected in increased income for the members. Thus, any benefit would generally be taxable. However, these organizations sometimes provide services to their members that, in effect, are items of personal expenditure. In pursuing their primary functions, it is sometimes necessary for them to engage in business activities or have operations that might be considered to be in competition with outside business operations.

In assessing the present tax treatment of these three types of organizations, it is necessary to relate their activities to the role they play on behalf of their members or the individuals contributing to their support. To the extent that such organizations perform functions similar to a consumer co-operative, the comments we have already made on organizations of that nature apply equally to them. That is, all benefits conferred on members should be brought into the income of such members to the extent it is practicable to do so, and any income retained by the organization should be taxed at the full corporate rate. Similarly, any loss arising from an activity of the organization that is carried on for the personal benefit

of members and not with a view to profit should be regarded as a personal expenditure and not deductible from other income in the current or any other year (but could be carried back two years and forward indefinitely for deduction from income from the same activity). This approach differs somewhat from the complete tax exemption at present extended to most of these organizations.

To the extent that the organization is thought to have a broader social purpose, the same reasons that support the concessionary allowance for charitable donations might be applied to at least some of the income of the organization. There would be little purpose in granting a concessionary allowance to individuals and then taxing the charitable organization on the receipt of such contributions. On the other hand, we have emphasized that there should not be any tax concessions that give one business a competitive advantage over another, and the present exemption of business income earned by charities could well be regarded as such an advantage. In addition, it is easier to control concessions if they are related to individuals and not extended to organizations which do not pass them on to the individual. Therefore, if any income exemption is to be extended to charitable organizations, it should be limited and, in particular, no business activity of a charitable organization should be given a competitive advantage.

Present and Proposed Tax Treatment

<u>Charitable Organizations</u>. The present general exemption from income tax for charitable organizations is contained in paragraphs (e), (f) and (g) of section 62(1) of the Act. Paragraph (e) exempts charitable organizations, whether or not incorporated, all the resources of which are devoted to charitable activities carried on by the organization itself; paragraphs (f) and (g) respectively, exempt charitable corporations and charitable trusts, each of which must meet certain stipulated requirements, and which may act as conduits for distributing funds to charitable organizations. In addition, paragraphs (ga), (gb) and (gc) of section 62(1) specifically exempt

certain housing corporations, the Canadian Universities Foundation, and non-profit corporations for scientific research, while some other housing corporations are exempt by virtue of section 62(1)(i). We recommend that these bodies should be treated in the same way as charitable organizations.

The word "charitable" is not defined in the Act, but the accepted definition of "charity" is that given by Lord Macnaghten in Pemsel v. Special Commissioners for Income Tax:

> "'Charity' in its legal sense comprises four principal divisions: trusts for the relief of poverty, trusts for the advancement of education, trusts for the advancement of religion, and trusts for other purposes beneficial to the community not falling under any of the preceding heads. The trusts last referred to are not the less charitable in the eye of the law because incidentally they benefit the rich as well as the poor, as indeed every charity that deserves the name must do, either directly or indirectly." 19/

The definition in the Pemsel case appears to us to be generally satisfactory for tax purposes. However, it has been held in England that a trust for the relief of poverty among the relatives of the settlor is charitable 20/. We suggest that the legislation specifically exclude the recognition of such a trust as a charitable body for income tax purposes.

Prior to the 1966 Budget there was no requirement for an organization to obtain recognition from the Department of National Revenue that it qualified as a charity under the relevant provisions of the Act. However, a directive was issued under the Income War Tax Act in 1948 which specified the types of organizations that would be recognized, primarily in connection with the claiming of a deduction for charitable donations made to such bodies. This directive has been followed under the Income Tax Act, and no further rulings have been issued 21/. It may be noted in passing that the four charitable purposes laid down in the directive do not all accord with those in the Pemsel case; though the first three purposes follow those of that case, the directive purports to confine purposes beneficial to the community to those "analogous to the three other purposes".

The Department appears to have attempted to administer the provisions of the Act dealing with charitable organizations somewhat restrictively. Apparently, as a general rule, section 62(1)(e) is treated as being limited to

organizations which actually operate charities, such as hospitals, as opposed to organizations which distribute their funds to other operating charities. Where possible, the Department attempts to bring charities under 62(1)(f) rather than 62(1)(e) 22/ because of the restrictions contained in (f), and also attempts to insist in many cases that charitable activity must be confined to Canada 23/.

We have elsewhere recommended the continued allowance of charitable contributions in arriving at the taxable income of donors. We have also recommended the use of a comprehensive tax base which includes in income all gifts received by the donee. Thus, in general, the beneficiary of a charitable contribution would be taxable on the benefits received, but only to the extent that they exceed his deductions and tax credits. If it was thought to be socially desirable to encourage taxpayers to make charitable donations, it would seem to be a negation of the objective to tax the income of the charitable organization. The primary purpose of a charity is to collect donations and then to apply these funds in the manner prescribed by the organization; it is not a basic function of a charity to be in business in competition with other business operations. Therefore, although it would appear reasonable to exempt from tax the donations received by a charity, the proper tax treatment of business income (as described below) is not so clear.

It is not uncommon for a charitable organization to have funds available in excess of its current requirements, and the investment of these funds to earn income is a reasonable function of the organization. Although it may not be reasonable to accumulate and hold these funds over a long period of time, or at least this may not be a function that warrants a special tax concession, we could devise no fair means of differentiating between charities in order to extend a selective concession based on reasonable accumulations. However, a second and more important question arises if such an organization engages in a business activity. Should a tax concession be extended to revenue from

this source? While an assessment of the reasonableness of the retention by charitable organizations of large amounts of their annual revenue is not a responsibility of this Commission, a conclusion on the tax treatment of competing businesses is required, and we recommend that the tax exemption should not be extended to business income.

By "business income" in this context we mean all income from a non-portfolio investment, whether it be an investment in an incorporated or an unincorporated business. Our concept of a non-portfolio investment essentially includes any interest of 10 per cent or more in a business, whether incorporated or not. For this purpose the ownership of real property is defined to be a business. The problems of defining a separate business and what should be considered to be business income are discussed in Chapter 22, and the conclusions reached in that chapter should also apply to charitable organizations. However, the approval procedure discussed below should minimize the difficulties of determining which income is to be taxable. One exception, for administrative convenience, would involve the exclusion of a certain minimum amount of income from occasional sales, for example, bazaars and rummage sales, and from small sales operations, such as gift shops.

Therefore, while most of the income or losses (contributions and portfolio income less expenditures related to the charitable purpose) of the charitable organization should continue to be excluded from the tax base, the income from non-portfolio investment should be subject to the full rate of corporation tax. Because portfolio income would be exempt from tax, the charitable organization should be refunded any corporation and withholding taxes collected on its behalf.

We consider that the present exemptions contained in paragraphs (e), (f) and (g) of section 62(1) should be combined into one exemption for charitable organizations, which would be modelled substantially on the present paragraph (e) but which would specifically include trusts for charitable purposes. It should be made clear that charitable organizations can

carry on their work inside or outside Canada. While the 1966 amendment provides partial relief in this regard, we would prefer that the definition be expanded further.

We also recommend that a supervisory body be established, composed of members of different departments of government, which might include the Department of National Health and Welfare and the Department of National Revenue, to grant tax-exempt status to charitable organizations. Once such approval was given, it would be subject to periodic review by the supervisory body. An appeal would lie from a decision of this body to the courts. Every charitable organization, to qualify for exemption, would be required to apply for approval to the supervisory body, which would then maintain (and perhaps publish) a list of approved charities. This might work some hardship in those cases where victims of a disaster within a community were given relief by a charitable organization newly established for the purpose. Often the response to such a campaign is great during the first fortnight or so when the disaster is news, but might be small by the time the charity could be expected to have received approval. Perhaps the answer to this problem would lie in requiring not prior approval, but approval at some time, in order to have the receipts recognized as deductions for tax purposes. This would not necessarily preclude the use of receipt forms issued by the tax authorities, which could be used on a tentative basis. It would seem that a system could be devised whereby the District Tax Office would have available official receipt forms, duly numbered, so that they could be identified.

It was suggested to us during the hearings that, in order for a charitable body to retain its qualification, it should have its statements certified each year by an independent auditor. After consideration, we concluded that, although obtaining a regular auditor's certificate might place an undue burden on many small charities, it would not be unreasonable to require the annual submission of a special certificate signed by the responsible officers of the charity and the auditor. Such a certificate

could attest to the existence of proper books and records maintained in a satisfactory condition, and could refer to a certain minimum checking of the accuracy of the statement of operations. Once a charitable organization had established a proper system, including its own verification procedures, such an annual reporting should not be onerous. As with any other organization, the books of account should be readily available for examination by the tax authorities; and because preferred tax treatment is involved, it might be advisable to require publication of the annual financial statements.

As part of the original (or any revised) application for approval as a charitable organization, applicants should be required to define the scope of their proposed activities and the types of revenue that they expect to receive. Because we recommend that the proceeds of the charitable activity should be excluded from the tax base of the organization, whether it resulted in a profit or a loss, it would be necessary to be relatively explicit as to what revenues and expenses were part of such activity. Contributions received, portfolio income, receipts from small bazaars, etc., should be excluded, as well as the ordinary expenditures connected with the charitable operation. However, any other business income should be specifically included in the tax base. Thus, the question of what income was to be taxable and what was to be exempt would be settled as part of the application procedure, and should produce only minor difficulties in subsequent years. The periodic review already referred to would include examination to ensure that the stated revenue allocations (taxable and non-taxable) were being adhered to.

Private Clubs and Similar Organizations. This second group consists of organizations at present exempt from tax if they qualify under section 62(1)(i) of the Act. This provision exempts "a club, society or association organized and operated exclusively for social welfare, civic improvement, pleasure or recreation or for any other purpose except profit...." These organizations may engage in activities with outsiders as well as with members, and the activities can give rise to profit on sales of goods and services and to various other kinds of income. To qualify for tax exemption, no part of

the income may be payable to, or otherwise made available for the personal benefit of, any proprietor, member or shareholder. Members therefore will not receive income directly as a result of the activities carried on. However, to the extent that such activities are profitable, the members will receive an indirect personal benefit through a reduction in dues or other charges below what would otherwise be necessary or, alternatively, the assets of the club itself will increase.

In practice, many clubs engage in activities with outsiders, presumably to the benefit of members, without losing tax-exempt status. The legislative requirement that "no part of the income...was payable to, or was...for the personal benefit of, any proprietor, member or shareholder" is difficult to interpret and apply and would appear to be of limited value.

Income might also be presumed to arise from activities of clubs involving members only. For example, if an individual makes an investment from which he derives income in the form of interest or rent, and spends the income on recreation, he will be taxable on the income but will not be allowed the cost of the recreation for tax purposes. When an individual invests in a recreation club, however, the investment and recreation activities are merged in the club and he does not receive any readily measurable income from his investment; the income that otherwise would have arisen has been used to reduce the cost of his recreation below what would have been necessary if he were acquiring it separately. In principle, income should be imputed to those individuals who merge these income-earning and personal benefit activities; there is no difference in the taxable capacity of those who merge the activities and those who do not. However, we have already concluded that, at least for the time being, income should not be imputed from assets employed for personal use and consumption.

Organizations of this nature are primarily intended to provide recreational facilities or other benefits on a collective basis for their membership, instead of having each member attempt to obtain the same benefits on an individual basis. Therefore, the cost to the members (fees) is a personal

expenditure, and there would be little purpose in taxing the organization on the receipt of such fees, as they in turn are expended on providing the recreational facilities. Just as for the charitable organization, any profit or loss on the conduct of the primary activity of the organization should be excluded from the tax base. However, in this case there is no reason to permit portfolio income to be received as part of this tax-exempt activity, for no broad social purpose is involved and, in effect, such income is used only to reduce the personal expenditures of the members. Similarly, any income from a business other than the primary activity of the organization should be taxable.

Because tax-exempt status is a privilege that should be closely regulated, we recommend that the same general procedure of initial application and annual returns suggested for charitable organizations should be followed here. The tax authorities, rather than a separate board, should pass directly on these applications, subject to appeal to the courts, and should publish a list of the organizations approved. The annual returns should include financial statements that show separately income from the operations of the approved activity and any other income. One section of the legislation, similar to the present section 62(1)(i), should set out the types of organizations eligible to apply. The requirements for maintaining eligibility would be established by regulation.

Because an organization would define its exempt activity in its initial (or any revised) application, it should not be unduly difficult to segregate taxable and non-taxable activities. It should be provided that membership fees and the revenue from dining and bar facilities attributable to their use by members and a limited number of guests are part of the exempt activity. Business with non-members should be defined to be a separate activity. Any other activities, for example, retail outlets, that were operated for the convenience of members, and any revenue from non-members received from the primary activity, should be permitted to be included in the exempt category as long as the total annual gross revenue of all such activities did not exceed a stipulated percentage, say, 5 per cent, of the gross revenue of the primary operation.

Organizations of this general type represent basically a non-dividend-paying form of consumer co-operative, and should be taxed in the same general fashion. Thus, a private club would be taxed on an amount equal to its undistributed property income and business income from activities unrelated to the primary activity of the organization. Distributions of such income would be taxable in the hands of the members, and should only be deductible to the extent that half of such payments had been paid unconditionally in cash, and they should be subject to the standard withholding tax of 15 per cent.

Thus, profits realized from exempt activities would not be subject to tax, and losses from these activities would not be eligible for offset against other income. This treatment differs in form, although it is unlikely to differ in substance, from that recommended for co-operatives, for any income, as well as any loss, arising from the primary activity of the club would be excluded from the tax base. We consider this necessary in order to eliminate the complexities of determining the amount of income of a private club under the standard rules when membership fees and large capital expenditures are involved. We do not feel that this procedure would produce inequities between private clubs and competing organizations.

A club, therefore, would not be permitted to accumulate property income or unrelated business income free of tax to subsidize the provision of personal goods and services to members. Also, because these organizations should be taxed in a manner similar to co-operatives, if eventually a procedure was established for imputing income on certain assets, the requirement should also apply to this group of organizations. In any event, the use of an imputed income provision would be preferable to any form of gross revenue tax, an alternative that has been suggested as a means of reducing the competitive advantage that tax-exempt organizations have over ordinary business operations.

<u>Other Non-Profit Organizations</u>. The general composition of this third group of organizations has already been discussed. It includes agricultural organizations, professional organizations, boards of trade, chambers of commerce, and labour organizations. The present tax treatment of these organizations is similar to that outlined for private clubs.

As the organizations contained in this group possess some special characteristics that set them apart from private clubs, we are proposing that they be taxed in a manner nearer to that recommended for charitable organizations. To reduce the advantages of the deferment of tax involved, we also propose that a postponement fee (discussed below) should be applied to income from portfolio investment that is not to be taxed at the corporate rate. Therefore, designation as an organization of this kind could be a valuable concession and should be limited in application. We recommend that the legislation should set out the general requirements for approval, that the tax authorities should pass directly on the applications and annual returns (subject to appeal to the courts), and that a list of those organizations that become qualified should be published. Because preferred tax treatment is involved, it might also be advisable to require publication of their annual financial statements as a condition of qualification.

Contributions and donations to these organizations, for example, membership fees and union dues, would not be deductible as charitable contributions, but would usually qualify as ordinary business or employment expenses. Although these organizations would make few disbursements to members, when they do occur, as in the case of strike pay, they would be included in the income of the recipient. We recommend that distributions to members should be deductible to the organization and taxable to the members.

We propose that the income of these organizations should be treated in the same general way as we recommend for the income of charitable organizations. Thus, the net income from non-portfolio investment should be taxed at the corporate rate, and portfolio income should be exempt from the corporation tax. Again, the primary activity of the organization, as defined in its application

for special tax treatment, should be an exempt activity for tax purposes, whether it resulted in a profit or a loss on operations. Membership fees and contributions, portfolio income, and a limited amount of revenue from ancillary activities would be specifically included in the exempt activity, and any corporation and withholding taxes applicable to such income should be refunded. Business conducted with non-members, other than the minimum allowed for administrative reasons, would similarly be defined to be a separate business. We also recommend that, because the portfolio and sundry business income would receive special tax treatment, the tax authorities should ensure that if such income was being used for the direct benefit of members it be reflected in their income. This last requirement should be a problem only if employee or shareholder benefits were derived through the organization.

These proposals provide opportunities for the substantial deferment of income through these organizations. This deferment could arise because contributions would generally be deductible, because portfolio income would not be subject to tax at the organizational level, and because members would only be taxed on their interest in the organization when benefits were received. Elsewhere in the Report we recommend that the tax advantages of such deferment should be reduced or eliminated, either by the imposition of a substantial withholding tax on any income that was not allocated (and taxed) to the beneficiary, or by the imposition of a postponement fee to compensate for the delay in the distribution of the income. In this case the latter alternative would appear to be preferable. Thus, any undistributed portfolio income should be subject to a postponement fee of up to 15 per cent. This fee would not be refundable, and the member would still be taxed in full on any benefits received.

Obviously an organization can have more than one purpose. However, it should be possible to classify each non-profit organization as a member of one of the three groups we have described. Where the organization had several purposes, and no one purpose clearly dominated, it would be reasonable to require that procedures be established to account separately for the activities related to each purpose.

CONCLUSIONS AND RECOMMENDATIONS

CO-OPERATIVES

1. Co-operatives should be taxed at the corporate rate on their taxable incomes.

2. Patronage dividends should be deductible in computing the taxable income of co-operatives to the extent that half of them had been paid unconditionally in cash, that is, the deductible amount of such dividends could not exceed twice the amount thereof paid in cash. There should be no other limitation on the deduction of patronage dividends.

3. Losses arising from the business activity of providing consumer goods and services to members of the co-operative should not be deductible from any other income of the co-operative, and should only be eligible to be carried back two years and forward indefinitely against income from the same activity. Business conducted with non-members should be considered as a source of income separate from the business with members.

4. The three-year exemption from tax of new co-operatives should be discontinued. However, the other provisions recommended for new and small businesses in Chapter 22 should also be available to co-operatives.

5. Patronage dividends, whether paid in cash or attributed, and including those relating to consumer goods or services, should be subject to a withholding tax of 15 per cent and should be included in the income of the member. The withholding tax would be calculated on the full amount of patronage dividends and deducted from the portion paid in cash.

CAISSES POPULAIRES AND CREDIT UNIONS

6. Credit unions and caisses populaires should be taxed at the corporation income tax rate on their taxable incomes.

7. Interest and dividends paid and credited to members, and interest rebates made on a patronage basis, should be deductible in computing the taxable income of credit unions and caisses populaires to the extent that half the amounts were paid unconditionally in cash.

8. Losses arising from the business activity of providing loans to members should not be deductible from any other income of the credit union or caisse populaire, and should only be eligible to be carried back two years and forward indefinitely against income from the same activity.

9. Interest and dividends paid or credited on deposits and shares, and interest rebates made on a patronage basis, should be subject to a withholding tax of 15 per cent (to be deducted from the portion thereof paid in cash), and should continue to be taxed to the recipients.

MUTUAL INSURANCE COMPANIES

10. Mutual general insurance companies should continue to be taxable at the corporation income tax rate. Life insurance companies are dealt with elsewhere.

11. Policy dividends paid and credited by life and general insurance companies should be deductible in computing the income of the paying companies and should be treated as income of the policyholders. Such dividends should be subject to a withholding tax of 15 per cent and should be included in the incomes of the recipients.

GOVERNMENTAL ORGANIZATIONS

12. No change is recommended in the taxation of bodies controlled by the federal or provincial governments or by municipalities.

PUBLIC UTILITIES

13. Privately owned public utility companies should be taxed at the same rate as other corporations.

MISCELLANEOUS TAX-EXEMPT ORGANIZATIONS

14. All organizations that are to have tax-exempt status for some of their activities should be required to apply for such exemption, and to file annual information returns and returns of income. Profits and losses on the operation of their primary activities (as defined) should be excluded from taxable income.

15. Charities should pay tax at the corporation income tax rate on business income, including income from non-portfolio investment, defined as any interest of 10 per cent or more in a business, but their other income should be exempt from taxation.

16. An interdepartmental supervisory body should be established to grant tax-exempt status to charitable organizations and to review this status periodically.

17. Private clubs and similar non-profit organizations which exist primarily for the personal benefit of their members should be taxed at the corporation income tax rate on their undistributed income, except that derived from their primary activities and other sources incidental thereto. They should be taxable on income from all other sources, including both portfolio and non-portfolio income. Distributions should be deductible to the extent that half of such payments were paid unconditionally in cash, and should be subject to the standard withholding tax of 15 per cent.

18. Other non-profit organizations, including agricultural organizations, professional organizations, boards of trade, chambers of commerce and labour organizations, should be taxed at the corporation income tax rate on the undistributed income from non-portfolio investment. On distribution, this income should be subject to gross-up and credit. Their undistributed portfolio income should be exempt from the corporation income tax, but should be subject to a postponement fee of, say, 15 per cent.

REFERENCES

1/ Aside from grain co-operatives, where outside financing is unusually significant, the ratio of financing by members' investment to outside financing has in recent years been running about 1.75 to 1.

2/ Now section 75(1).

3/ This restriction is now contained in section 75(3) which, in effect, allows certain interest payments to be calculated as part of income for the purpose.

4/ Now section 75(2).

5/ Now section 73(1).

6/ Section 62(1)(k).

7/ In the case of credit unions, the capital invested by the members is usually represented by shares, whereas in the case of caisses populaires it is largely in the form of deposits. The caisses populaires lend a considerably higher portion of their funds in the form of mortgages on real estate. Credit Unions in Canada, Ottawa: Department of Agriculture, 1964, gives the following information in this respect for 1963 (the institutions in Quebec being mostly caisses populaires and those in other provinces being mostly credit unions):

	Percentage of Total Liabilities	
	Quebec	Rest of Canada
Shares	11	72
Deposits	82	14

	Percentage of Total Assets	
	Quebec	Rest of Canada
Mortgages	40	14

8/ The relative importance of shares and deposits as a means of obtaining funds varies from one province to another. Dividends are roughly synonymous with interest. For the purpose of simplicity, from this point on the phrase "interest on shares and deposits" should be interpreted to include all dividends paid on shares.

9/ In determining this economic gain, a member's interest in the retained unallocated earnings is probably of no value. Unlike an interest in an ordinary corporation, it is not realizable by sale, and on a winding-up of the organization, because of provincial laws, there is often no possibility (or at best a remote possibility), that the member will receive any part share of the retained earnings.

10/ Where the money borrowed is used to earn income from a business or property, any differential is automatically taxed because it reduces interest expense.

11/ These exemptions are provided for in section 62 of the Act. For convenience we shall treat the term "organization" as including a trust.

12/ For example, the exemption of credit unions and caisses populaires, new co-operatives (for three years) and government-owned public utilities are referred to elsewhere in this chapter; trusts under various types of employee benefit plans are dealt with in Chapter 16; personal corporations are discussed in Chapter 19; and foreign business corporations in Chapter 26.

13/ Section 62(1)(b).

14/ Section 62(1)(c).

15/ Section 84 of the Income Tax Act, and the Financial Administration Act, R.S.C. 1952, Chapter 116, Schedule D.

16/ The British North America Act provides in section 125 that "No lands or property belonging to Canada or any province shall be liable to taxation". It appears from decided cases that even if this section did not exist, it would be inconsistent with the scheme of the Act to permit the federal government to tax a province or vice versa.

17/ The Corporations Tax Act, R.S.O. 1960, Chapter 73, section 58, and The Corporation Tax Regulations (Ontario), section 801

18/ Section 85.

19/ (1891) 3 T. C. 53, p. 96.

20/ Goff v. Webb (1602) Toth 30; White v. White (1802) 7 Ves. 423.

21/ Department of National Revenue, Information Bulletin No. 17, outlines in general the qualifications required for charitable donations.

22/ The enactment of the provision dealing with charitable trusts (the present section 62(1)(g)) was made necessary by court decisions which held, in effect, that a trust for charitable purposes was not a "charitable institution" and presumably would not qualify as a "charitable organization" under section 62(1)(e). M.N.R. v. Trusts and Guarantee Company Limited, [1940] A.C. 138; Executors of the Honourable Patrick Burns v. M.N.R., [1950] A.C. 213.

23/ However, the Budget of March 29, 1966, proposed that under certain circumstances recognition be given to contributions to non-resident charities.

CHAPTER 21

TRUSTS

Broadly speaking, a trust arises when property is transferred to a person, the trustee, who by accepting the trust undertakes to hold such property for the benefit of the beneficiaries of the trust. The trustee holds title to the trust property and usually has certain powers of management over it, but the income from, and the capital or "corpus" of, the trust property will ultimately be distributable to the beneficiaries in accordance with the terms of the trust 1/. Trusts may be created during one's lifetime or by will, and may endure for varying periods of time. The income from trust property may be distributed as received or after a period of accumulation; the capital of the trust may be partially distributable during the term of the trust, but any part not so distributed is distributable on its termination. The beneficiaries of a trust may be identified at the outset or only over a period of time. The beneficiaries entitled to income and those entitled to capital of the trust may or may not be the same. The rights of the beneficiaries to income and capital may be specified in the trust, or the trustee may be given a discretion to distribute or to accumulate income, to hold or distribute the corpus, or to select from members of particular classes of possible beneficiaries those to whom distributions of income or capital will be made.

The trust is a very flexible legal instrument that can be adapted to a variety of purposes. It is this very flexibility which makes it difficult to tax trusts properly and fairly, not only in comparison with other forms of intermediary such as partnerships and corporations but also in comparison with property transferred directly to a beneficiary rather than through a trust.

While there are problems associated with the taxation of other property that flows through a trust, it is the taxation of gifts to a trust that

causes the most difficulties. Under the present tax system such gifts are, in general, subject to either a gift tax or an estate tax. These taxes apply to a transfer of property to be held in trust in exactly the same manner as a transfer made directly to a donee. The liability for payment of these taxes rests primarily on the donor or his estate. We have proposed that the gift tax and the estate tax should be eliminated, and that gifts should be included in the income of the recipient as part of the comprehensive tax base. We have also recommended that the donee should be primarily liable for the tax, although in some circumstances the donor might have an obligation to withhold tax. Under this proposal a trust would include in its tax base not only the income from a business or from property but also any gifts or bequests which it received.

A trust is an intermediary, much like a corporation or a co-operative, and, as such, is a conduit through which income passes on the way to the beneficiaries. As a conduit, the trust does not in itself have a taxable capacity, but rather represents the individuals who are its ultimate beneficiaries. Thus, any taxes levied on the trust should be regarded as having been collected on behalf of the individuals who are the ultimate beneficiaries of the income being taxed.

Throughout this Report we have stressed the importance of equity and neutrality in the tax system, which means that individuals should be taxed on substantially the same basis regardless of whether income is received directly or is accumulated by an intermediary. We have pointed out that to attain greater equity it is necessary not only that the tax system should be as neutral as possible in its impact but also that all taxpayers should pay their tax liabilities as soon as their ability to pay has increased, whether the increase was direct or indirect.

To attain these objectives it is necessary that different types of intermediaries should be treated in the same way for tax purposes, as far as this is possible. We have proposed that a corporation should pay tax

at the top personal rate of 50 per cent; that amounts distributed or allocated to the shareholders should be included in their incomes, grossed-up to include the tax; and that the shareholders should be entitled to a credit for the tax paid by the corporation. We propose the same basic approach to the treatment of trusts. Accordingly, trusts should be taxed in much the same way as other types of intermediaries that accumulate income for the individual, and income of a trust (including gifts) should be brought into account at the same time as income of any other intermediary or individual. The trust should be regarded as an instrument to be employed for good personal or business reasons and should not be permitted to be used as a tax-avoidance device.

For these reasons the provisions applicable to trusts should be analogous, as far as possible, to those proposed for corporations. There are a number of difficulties, discussed later in this chapter, that arise when applying such a procedure to trusts. Accordingly, while our proposals for the taxation of trusts are consistent in principle with those for the taxation of corporations, they necessarily differ in detail.

Trusts frequently receive gifts or bequests which would be free of tax under our proposals if received by the ultimate beneficiary, who was a member of the family unit of the donor. It would obviously be unfair to tax the trust on such income and require the beneficiary to claim a refund, particularly if his right to the gift, and therefore the refund, could not be established for a considerable period.

To meet these difficulties, we propose a number of modifications to the general approach which we have adopted for dealing with intermediaries. The major modification we propose is to permit a trust to pay tax at the rates which would be applicable if a prospective beneficiary had received the payment directly, rather than at the top personal rate 2/. This would result in neutrality of treatment between a gift made directly to a beneficiary and a gift to be held in trust for him. It is important that

a direct gift should not be taxed either more or less favourably than a bequest in trust for the same prospective beneficiary. If, however, the terms of the trust were such that the prospective beneficiary could not be determined with reasonable probability, the trust would pay tax at the top personal rate.

TERMINOLOGY

The divisibility of property into many successive interests, limited in time and enjoyment, made the development of the trust possible. But at the same time it created the necessity of the trustee, as fiduciary, being held strictly accountable for all the various interests in the property held by the trust. Because some beneficiaries may have an interest only in the income of the trust, while others have rights to distributions out of capital, the division between capital and income is one which is fundamental to trust law. A trustee must, under the applicable trust law and trust instrument, determine for whose benefit various kinds of payment are received, and against whose interest in the trust, expenditures should be charged.

The terms "income" and "capital" have meanings which are reasonably well defined under trust law, and it is common in wills or other trust instruments to provide for payments out of income or payments out of capital. However, income as determined for the purposes of trust law may not be the same as income determined for tax purposes. For example, if a trust receives a stock dividend from a corporation, the stock dividend will be capital for trust purposes, but may result in income to the trust for tax purposes. Depreciation would normally not be taken into account in determining income under a trust instrument, but capital cost allowances would be deductible and recapture of depreciation would be includible in computing income for tax purposes. While gifts, bequests, and certain property gains are regarded as capital under a trust instrument, under our proposals they would be treated as income. For these and other

reasons, it is quite possible that the income of a trust for trust purposes may be either greater or less than the income for tax purposes. Accordingly, under our proposals the distinction between income and capital for trust purposes would not be relevant, and the significant factor for income tax purposes would be whether a distribution was made from income of the year as determined for tax purposes or was made from accumulations.

In this chapter we use the term "income" only in the sense in which it is used for tax purposes, unless the context clearly indicates otherwise. We use the expression "current income" to mean income earned or otherwise arising in a trust in a particular year. By the terms "accumulation" or "accumulated income" we mean amounts that were received by the trust as income or otherwise in a prior year, but were not distributable to beneficiaries in that year and have been retained in the trust.

When we refer in this chapter to an amount being "distributable" in a particular year, we mean that it is either distributed in that year or the beneficiary has a right to enforce payment of it in the year. The amount would be included in the beneficiary's income (unless it was an amount which was tax free to him) at the time it became distributable to him under this definition.

The above-mentioned terms are significant, because the treatment of amounts distributable to a beneficiary out of current income would differ from the treatment of amounts distributable out of accumulations. If the "income" as determined for trust purposes was greater than the income as calculated for tax purposes, the amount distributable to an "income beneficiary" may be regarded for tax purposes as partly a distribution out of current income and partly a distribution out of accumulations. On the other hand, if the "income" as determined for trust purposes was less than the income as determined for tax purposes, the amount distributable to "income beneficiaries" would be entirely out of current income, and the balance of the income as determined for tax purposes would be distributed to "capital beneficiaries" or accumulated.

PRESENT TAXATION OF TRUSTS

Property received as a gift by a trust is now treated as corpus of the trust, and is not taxed as income of the trust any more than a gift received by an individual is taxed as his income. To avoid confusion we will use the term "trust fund" when speaking of the corpus of a trust. Income of a trust under the present law is either income from property, such as interest, dividends or rent, or income from a business carried on by the trust. Income which is accumulated rather than distributed usually becomes part of the trust fund, although its disposition will depend upon the terms of the trust instrument.

The income tax treatment of trusts is provided for in section 63 of the Income Tax Act. A trust is treated as a separate tax-paying entity, taxable on its income at the same rates as an individual, but is not entitled to any personal deductions. However, in some respects a trust is regarded as a conduit and may deduct any part of its income which is paid or payable to beneficiaries in the year. Such distributions are taxed to the beneficiaries as their income. Accordingly, in considering the taxation of the income of a trust for a particular period, one must differentiate between the income which is distributed to the beneficiaries and that which is accumulated in the trust.

The conduit principle is also applicable to a number of deductions. The trustee may allocate among the beneficiaries the capital cost and the depletion allowances which he could otherwise claim. Tax credits such as the dividend tax credit and the foreign tax credit, that would otherwise be available to the trust, may be claimed by the beneficiaries to the extent that such credits are allocable to the income paid or payable to them.

The Income Tax Act, in common with the United Kingdom and United States legislation, has provisions to prevent avoidance of tax where the taxpayer transfers property to a spouse or a minor child, or where the taxpayer retains a benefit in or specified rights over the trust property 3/.

There are also provisions to prevent the reduction of tax payable by trusts on accumulated income by the creation of "multiple" trusts 4/.

The basic method of taxing trusts with respect to currently distributed income is similar in Canada, the United Kingdom and the United States. This method seems reasonable and is consistent with our overall approach of treating the intermediary as a conduit, and taxing the income in the hands of the beneficiary. It is in dealing with accumulated income and distributions of capital that most of the problems appear, and the methods of the three countries differ. In addition, our recommendation to tax gifts in the hands of the donee would add a new factor to the taxation of trusts.

A summary of the main features of the taxation of trusts in the United Kingdom and the United States is given in Appendix B to this Volume.

PROPOSED TAXATION OF TRUSTS

Proposal in Outline

A trust is an entity which acquires property by way of gift, or bequest, or for a consideration, and earns income from the holding or disposal of property, from business, or otherwise. It incurs expenses in the process of earning income. It makes distributions to beneficiaries either out of current income or out of accumulated assets. Accordingly, a trust is an intermediary for the beneficiaries. The trustee is in a fiduciary position which is somewhat similar to that of the directors of a corporation or a co-operative. In these circumstances, it is our opinion that for reasons of equity, neutrality, and administrative convenience, a trust should be responsible for filing returns and paying an initial tax on the income of a trust, but that the ultimate burden of tax should be borne by the beneficiaries and should be measured by their ability to pay. The trustee should have no personal liability to pay tax, except out of the assets under his control.

We have recommended that income tax should be imposed on corporations

at the top personal income tax rate of 50 per cent. The income of a corporation could then be distributed or allocated to the shareholders, who would be entitled to refunds if they were taxable at lower rates. Trusts differ from corporations in a number of important respects which may be summarized as follows:

1. Trusts often receive gifts and property passing on death, which, under our proposals, would not be included in income if received by a member of the family unit of the donor but would otherwise be included in income. The beneficiaries or possible beneficiaries of a trust may include members of the donor's family unit.

2. The profits of a corporation can be distributed or allocated to the shareholders year by year. While the ownership of the shares may change, the persons entitled to any distributions which may be made at any particular time can be readily determined. This is not always feasible in the case of a trust because the interests of the beneficiaries are often discretionary or contingent. The ultimate beneficiary of accumulated income, including gifts or bequests, may not be known for a number of years.

3. The interests of shareholders in a corporation can be bought or sold from time to time and, in the case of publicly held corporations, the shares are freely marketable. Interests of beneficiaries in trusts are often not readily salable, particularly because they are often contingent and depend, for example, upon whether the beneficiary or some other person will be alive at the time of the vesting of his interest. Accordingly, the beneficiary usually realizes on his interest in a trust only when it is distributed to him. One exception to this is a trust which issues transferable units, such as an investment trust, or unit holders' trust, which is discussed later in this chapter.

Our recommendations for the taxation of trusts differ from those relating to corporations in some ways in order to take account of these differences.

However, our recommendations are intended to accomplish the same general objectives, and to achieve as far as possible neutrality of treatment of gifts and other income, whether received by trusts, corporations or individuals. Our proposals are designed to impose tax on trusts at equitable rates and to prevent the use of trusts to avoid or defer payment of tax.

We recommend that gifts or other income received by trusts should be subject to an initial tax. In the absence of a special provision to the contrary, the rate of initial tax should be the top personal rate of 50 per cent. However, where a gift or other income was distributable currently, the beneficiary should be entitled to elect that the income would be taxable to himself, with the result that the trust would not pay tax. In the case of a gift or bequest or other income which was not distributable currently, but which was accumulated in a trust for the benefit of a prospective beneficiary who could be identified with reasonable probability, the prospective beneficiary should be entitled to elect that the initial rate would be the rate which would have been applicable if he had received the income directly. Where the trust received a gift or bequest and the beneficiary who was entitled to the income from the gift or bequest or the prospective beneficiary of the corpus was a member of the family unit of the donor, there should be no initial tax on the gift or bequest. However, where the prospective beneficiary or beneficiaries could not be identified with reasonable probability, or where no election was made, the initial tax would be payable at the 50 per cent rate.

When a trust distributed property to a beneficiary there would be a disposition, and the trust should be deemed to have received the fair market value, unless the distribution represented property given to the trust, and the beneficiary was a member of the donor's family unit. This is consistent with our proposals outlined in Chapter 15 that the making of a gift should be a disposition that would be deemed to have been made at the fair market value of the property given. It is also consistent with our recommendation

that upon a distribution of property by a corporation to its shareholders there should be a disposition at fair market value. This proposal would affect the amount of income which had accrued in the trust and which would therefore be subject to initial tax in the trust. It may be significant under our rules relating to the order of distribution in determining what part of the amounts distributed would be included in the incomes of the beneficiaries.

An amount distributed or distributable by a trust to a beneficiary should be included in his income unless the amount represented a gift and the beneficiary was a member of the donor's family unit. The amount distributable would be grossed-up to include any initial tax which had been paid by the trust, and the beneficiary would be entitled to a credit for the tax paid.

If a trust had been established prior to the effective date of the legislation implementing our proposals, the amounts ultimately distributed should be free of tax to the extent of the value of the property held in the trust on the effective date. Such property may already have been subject to gift tax, estate tax, or income tax, or may represent capital gains which had accrued prior to the effective date.

Where a trust received a gift or other income which was distributable to a beneficiary in the same year in which it was included in income, the implementation of our proposals should be fairly simple. However, in relation to a gift or other income which was accumulated for distribution at a later time, particularly if the rights of the beneficiaries were contingent or depended upon the future exercise of a discretion, the provisions required to implement our proposals would necessarily be more complex.

In some cases, there is one general trust fund from which various payments and distributions are to be made to various beneficiaries. In other cases, a trust is divided into different funds which are to be held for different beneficiaries. In order to simplify the calculation of initial rates of tax and to deal with all beneficiaries as equitably as possible, we propose that if a fund was established under a trust and was required to be

kept separate from other assets of the trust, the fund should be regarded as a separate trust for the purpose of calculating the initial rate of tax and for the purpose of determining the tax credit to which the beneficiary will ultimately be entitled. Similarly, if specific property was to be held in trust for distribution in a particular way, it should be treated as a separate trust for these purposes. References in this chapter to a trust should be taken to include reference to such a fund or such specific property where applicable.

Our basic proposals are set out in Tables 21-1 and 21-2. They may be summarized as follows:

1. The income of a trust, calculated in the same way as the income of any other taxpayer, and including gifts and bequests, should be subject to an initial tax for which the beneficiaries (other than non-residents) would receive credit. In the absence of a special provision to the contrary, the initial tax would be at the top personal rate of 50 per cent, but this would be subject to the special provisions referred to below.

2. A resident beneficiary to whom income was distributable in the year it became income of the trust would be entitled to elect that he, rather than the trust, would be subject to tax on the income. Where such an election was made, the trust would not be entitled to a refund of tax in respect of dividend income, interest income, or foreign income, which was distributable to the beneficiary who made the election, but that beneficiary would be entitled to credit for his proportion of the tax which would be refundable to an individual receiving such income.

3. If income was not distributable in the year in which it was earned, but was accumulated, its treatment would depend upon whether there was a "prospective beneficiary" for whom it was being accumulated. An individual would be a prospective beneficiary of an amount if it was indefeasibly vested in him, or if he would be entitled under the trust

instrument to receive the amount, if he was living, not later than the death of an income beneficiary who was older than he by at least ten years or on his attaining a specified age not exceeding forty years, or on the later of these events if both conditions were applicable.

4. If trust income consisted of a gift or bequest and:

   a) it was distributable in the year to a member of the donor's family unit,

   b) it was held for a prospective beneficiary who was a member of the donor's family unit, or

   c) all the income from the given property as determined either for tax purposes or trust purposes was distributable to one or more members of the donor's family unit,

   no initial tax would be payable on the gift or bequest.

5. If a gift was accumulated in a trust for a prospective beneficiary other than a member of the donor's family unit, or if income other than a gift was accumulated for any prospective beneficiary, the prospective beneficiary would be entitled to elect that the initial tax would not be calculated at the rate of 50 per cent, but would be the amount of additional tax which would have been payable by him (i.e., the total tax he would have paid if he had received the income directly, less the tax actually payable by him on his income).

6. If a gift or bequest was accumulated in trust, and no election was made as described in paragraph 5, whether or not anyone was eligible to make such an election, a life tenant or other income beneficiary who was entitled to all the annual income derived from the gift or bequest would be entitled to elect to receive interest from the government each year at the rate of, say, 5 per cent or 6 per cent on

the amount by which the 50 per cent initial tax exceeded the tax which would have been payable if the gift which produced the income distributable to him had been taxed as part of his comprehensive tax base.

7. When property was distributed to a beneficiary, the trust would be deemed to have disposed of the property at its fair market value and any resulting gain or loss would be taken into account in computing the initial tax unless the property was a gift which was distributed to a member of the donor's family unit.

8. A beneficiary would include in his comprehensive tax base all amounts which became distributable to him from a trust in the year, whether out of income or corpus. This should be subject to the following exceptions:

   a) A gift received by the trust which was distributable to a member of the family unit of the donor would not be regarded as income.

   b) Amounts distributable out of trust assets on hand at the effective date of the legislation would be tax free. Property gains which had accrued in the trust up to the effective date would be free of tax to the same extent as similar gains of any other taxpayer.

9. The initial tax on any income would be deemed to have been paid by the trust on behalf of the beneficiary who ultimately became entitled to the income, in the same way as a withholding tax. Accordingly, the amount which he would be entitled to receive from the trust would be reduced by the amount of the initial tax deemed to have been paid thereon.

10. Amounts distributable to a beneficiary and included in his income would be grossed-up to include any initial tax paid. The beneficiary would receive credit for the initial tax, and if it exceeded his tax

otherwise payable, he would be entitled to a refund of the excess. Our proposed rules for determining the rate of initial tax which had been paid on any particular distribution are discussed later in this chapter.

11. Where trust income, other than gifts and bequests, was distributable in the year to a non-resident beneficiary, or was held for a non-resident prospective beneficiary, the 50 per cent initial tax would not be reduced and amounts distributed to the beneficiary would be subject to a withholding tax at the rate applicable to dividends. However, the non-resident beneficiary would be entitled to elect that instead of the 50 per cent initial tax and the withholding tax, the income payable to him would be subject to the same withholding taxes as if the income had been paid to him directly. Gifts and bequests which were distributable to a non-resident beneficiary would be subject to initial tax at the rate of 30 per cent, and no further withholding tax would be payable.

It will be seen that the tax treatment we propose would depend upon the type of income of a trust, or of a fund established under a trust, the time at which the income was distributable, and the type of beneficiary who was entitled or expected to receive the income. This tax treatment is set out in Tables 21-1 and 21-2.

Table 21-1 shows our proposed tax treatment of gifts received by a trust, including property passing on the death of an individual to the trust arising on his death.

Table 21-2 shows the proposed tax treatment of income of a trust other than gifts and bequests. This would include income from trust property, and property gains realized by a trust.

TABLE 21-1

PROPOSED TREATMENT OF GIFTS RECEIVED BY A TRUST

	Type of Beneficiary	When Distributable a/	Proposed Tax Treatment b/
1.	Member of donor's tax unit	Currently	Free of tax
2.	Member of the donor's tax unit was prospective beneficiary	At future time	Free of tax
3.	Beneficiary not a member of donor's tax unit, but a member of donor's tax unit was entitled to the annual income from the property given or bequeathed	At future time	Free of tax
4.	Resident who was not a member of donor's tax unit	Currently	Taxable, but beneficiary may elect to include gift or bequest directly in his income in which case no initial tax would be payable
5.	Resident who was not a member of donor's tax unit was prospective beneficiary (unless 3 above applicable)	At future time	Taxable, but prospective beneficiary may elect that initial tax payable by trust would be the amount of additional tax that would be payable if he had received the gift or bequest directly c/
6.	Prospective beneficiary not determinable	At future time	No elections provided c/
7.	A non-resident was beneficiary or prospective beneficiary	Currently or in the future	Initial tax will be at rate of 30 per cent; no withholding tax on distribution

a/ "Currently" means that the gift is distributable to a beneficiary in the year in which it is income of the trust. "At future time" means that it is not distributable to a beneficiary within that year, so that the gift is "accumulated" in the trust.

b/ Except where otherwise indicated the trust would pay initial tax at the rate of 50 per cent.

c/ If item 5 was applicable and no election was made thereunder, or if item 6 was applicable, and if all the income from the property given or bequeathed was distributable annually to a resident beneficiary, the trust would pay initial tax at the 50 per cent rate, but the income beneficiary would be allowed to claim interest from the government at 5 per cent or 6 per cent per annum on the difference between this initial tax and what his tax would have been if he had received the gift directly.

TABLE 21-2

PROPOSED TREATMENT OF OTHER INCOME RECEIVED BY A TRUST

	Type of Beneficiary	When Distributable a/	Proposed Tax Treatment b/
1.	Resident, whether or not a member of testator's or settlor's family unit	Currently	Taxable, but beneficiary may elect to include amounts directly in his income in which case no initial tax would be payable
2.	Resident, whether or not a member of testator's or settlor's family unit	At future time	Taxable, but prospective beneficiary may elect that initial tax payable by trust would be the amount of additional tax that would be payable if he had received the income directly
3.	Prospective beneficiary not determinable	At future time	No elections provided
4.	Non-resident beneficiary or prospective beneficiary	Currently or in the future	Initial tax at the 50 per cent rate and further withholding tax on all distributions at the rate applicable to dividends. But the beneficiary or prospective beneficiary would be entitled to elect that instead of this initial tax and withholding tax the income would be subject to the same withholding taxes as if he had received it directly

a/ "Currently" means that the gift is distributable to a beneficiary in the year in which it is income of the trust. "At future time" means that it is not distributable to a beneficiary within that year, so that the gift is "accumulated" in the trust.

b/ Except where otherwise indicated the trust would pay initial tax at the rate of 50 per cent.

We will now discuss some aspects of our proposals in greater detail.

Transitional Provisions

We do not intend that the proposed system of taxation of trusts and their beneficiaries should be retroactive. The gifts and bequests held by trusts at the effective date of the legislation may already have been

subject to gift tax or estate tax. Trust assets on hand at that date may also include capital appreciation which under our proposals should continue to be tax free. Accordingly, the assets held by trusts, other than inventory, which were on hand at the effective date would have to be valued in the same manner as property held by any other taxpayer at that date and gains which had accrued to the effective date would be free of tax to the same extent as similar gains of any other taxpayer. This latter subject is discussed in Chapter 15.

Subject to the exceptions relating to inventories of a business and to the recapture of depreciation which are already subject to tax on realization of the property, the gains which had been realized or had accrued up to the effective date would not be subject to initial tax in the hands of the trust, and would not be taxable to the beneficiaries when distributed. However, gifts or bequests received and property gains accruing after the effective date would be subject to initial tax in the hands of the trust, and would be included in the income of the beneficiaries when distributed to the extent and in the manner outlined in this chapter.

Order of Distribution of Trust Assets

Because some accumulations in a trust may be tax free because they were gifts accumulated for a member of the donor's family unit or amounts accumulated to the effective date of the legislation, and others may be taxable on distribution on one basis or another, it would be necessary for each trust to keep records of current income and the initial tax paid thereon, and of accumulations of income and the initial tax paid thereon. If the trust existed before the effective date of the legislation, any remaining trust property would represent assets on hand at the effective date.

In our opinion, it would be essential to adopt rules settling the order in which amounts were distributable by a trust. This would be necessary in order to determine which distributions to beneficiaries would be taxable under our proposals, and which would be free of tax as distributions of gifts

to members of a family unit or as property on hand at the effective date of the legislation. In the case of a taxable distribution, it would also be necessary to determine the rate of initial tax which had been paid on the amount distributed to determine the tax credit available to the beneficiary. We propose that the order of distribution should be as follows:

1. Amounts distributable in a year would first be regarded as having been paid out of the income of the trust for that year, to the extent of that income. If the trust had paid initial tax on that income, the beneficiary would gross-up the distribution to include the initial tax at the rate paid by the trust, and would obtain credit for this tax.

   Amounts distributable in one year to two or more beneficiaries in the same class under the trust instrument, would be pro-rated among the beneficiaries. If the beneficiaries were not in the same class, amounts distributable out of income would be attributed first to the beneficiary or beneficiaries who were income beneficiaries under trust law, and then to those who were capital beneficiaries under trust law.

2. Distributions would next be considered to have been paid out of accumulations on which the trust had been subject to initial tax. The beneficiary would gross-up any such distribution to include the initial tax attributable thereto, and would obtain credit for the initial tax.

3. If the trust had received gifts free of initial tax on the ground that they were received for the benefit of a member of the donor's family unit, further distributions would be regarded as distributions of those gifts which would not be taxable to the recipient if he was a member of the donor's family unit, but otherwise they would be taxable.

4. Any further distributions would be considered to have been paid out of property on hand at the effective date of the legislation and would be free of tax in the hands of the beneficiary.

This order of distribution would be applicable to each trust. However, as we have indicated earlier, if specific property was held in trust for disposal in a particular way, or if a separate fund was established within a trust, it should be treated as a separate trust fund. It would not be pooled with other assets of the trust in determining the order of distribution, and the initial tax on the property and the credit available to the beneficiary would be calculated separately.

Income Currently Distributable

Income of a trust may consist of gifts or bequests, business income or property income. All such income should be subject to initial tax at the top personal rate of 50 per cent, unless the rate was reduced by reason of an election (as referred to below). However, a gift which was for the benefit of a member of the donor's family unit would not be regarded as income, and would not be subject to initial tax.

In Chapter 17 we recommend that where a gift arose on death it should be included in the donee's income at the time of actual or constructive receipt, but, in any case, not later than twenty-four months after the date of death. We also propose that if the identity of the donee was not known twenty-four months after the date of death, the gift should then be included in the income of the trust arising on death. If the gift was to be held in trust under the terms of a will, it should be included in the income of the trust at the time letters probate or letters of administration were obtained; but, in any event, not later than twenty-four months after the date of death.

If a trust received a gift which was distributable immediately to a member of the donor's family unit, or if a bequest was made to a member of the family unit of the deceased, the trust (or estate) and the beneficiary should file appropriate returns to establish this fact. In that case the trust would not be subject to initial tax and, upon receiving the gift from the trust, the beneficiary would not be subject to tax.

If a trust received a gift which was distributable immediately, or if a bequest was distributable immediately to a beneficiary who was not a member of the donor's family unit, it would be subject to tax. If a trust had income other than a gift, which was distributable within the same year, it would be subject to tax whether or not the beneficiary was a member of the donor's family unit. In both of these cases the trust would be liable to pay initial tax on the income at the rate of 50 per cent, unless an election was made as referred to below. The initial tax would be deemed to have been paid on behalf of the beneficiary as a withholding tax and accordingly the amount payable by the trust to the beneficiary would be reduced by the amount of the initial tax applicable thereto. On distribution, the beneficiary would include in his income the amount he received, grossed-up to include the initial tax, and would be entitled to a credit for the initial tax. In this way the treatment of trust income which was currently distributable would be similar to that provided for in the case of corporate income.

However, the imposition of an initial tax at the rate of 50 per cent might cause hardship if the beneficiary was taxable at a substantially lower rate, or if the income which was distributable was a gift consisting of property other than cash or marketable securities. Accordingly, a resident beneficiary should be entitled to file an election that the trust would not be subject to an initial tax at the 50 per cent rate on income which was distributable during the year to the beneficiary, and that he would be subject to tax on such income which was distributable to him. The income would be taxable in his hands on the same basis as if he had earned or received it directly rather than through the trust. The trust would, of course, be required to file a return reporting this income and the amounts distributable to beneficiaries in the year. The right to make an election of this kind would simplify the procedure for the trustee, for the beneficiary, and for the tax authorities. It would be analogous to an election by a corporation to be taxed as a partnership.

If a trust received dividend income, or if income was attributed to it by a Canadian corporation, the trust would normally be entitled to a credit for the 50 per cent corporation income tax. However, if an income beneficiary elected to be taxed directly on all of the income, the trust should not be entitled to this credit, but rather it should go directly to the beneficiary. Similarly, the trust would not be entitled to a refund in respect of withholding tax on interest income or to a credit for foreign tax on income from foreign sources. These amounts, as far as they were allocable to an income beneficiary who elected to be taxed on the income directly, would be credited to him. The amounts distributable to the beneficiary would be grossed-up to include the total amount of tax credits allocable to him, and he would be entitled to deduct these credits from the tax otherwise payable by him.

If property was settled in trust for the benefit of a minor, with power to the trustee to use the income of the trust fund or any part thereof for the benefit of the minor until he attained the age of 21 years, the income used for the benefit of the minor would be treated as his income. In most cases this would probably be taxed as part of the income of the family unit of which the minor was a member.

Income Accumulated

If a gift or bequest received by a trust was not distributable to any beneficiary in the year in which it was included in income, it would be subject to an initial tax in the hands of the trust unless it was to be held in trust for a member of the donor's family unit. Income other than a gift or bequest which was not distributable currently but was to be accumulated in the trust would also be subject to an initial tax in the hands of the trust. The initial tax would normally be at the top personal rate of 50 per cent. However, this may cause hardship if the property

was to be held in trust over a long period, and if the ultimate beneficiary would be taxable at a substantially lower rate. The hardship would be such that it could not be adequately relieved by the eventual payment of interest to the beneficiary on the overpayment of tax. Accordingly, where there was a prospective beneficiary to whom the accumulated income would probably be distributed, the prospective beneficiary should be entitled to file an election that the initial rate payable by the trust would be the amount of additional tax which he would have paid if he had received the income directly.

For the purpose of applying these provisions, a person should be regarded as a prospective beneficiary under a trust only if the terms of the will or other trust instrument were such that he was likely to receive the trust property. On the other hand, it would seem unduly rigorous to require that the property be fully vested in him. We suggest that an individual should be considered a "prospective beneficiary" of an amount if it was indefeasibly vested in him or if the terms of the trust were such that he would receive the amount in question if he was living, not later than either of the following events (or than the later of the following events if both must occur):

1. On the death of an income beneficiary who was older than he by at least ten years.

2. On his attaining an age specified in the trust instrument not exceeding forty years.

This definition of a "prospective beneficiary" would provide a reasonable test of whether a remainderman would be likely to receive the corpus of the trust or a portion of it in the normal course of events. Sometimes the possession and vesting of an amount would be deferred until the death of an income beneficiary who would usually be a generation older than the remainderman. In other cases, possession and vesting would be deferred

until the beneficiary reached a mature age, which ordinarily would not exceed forty years. While this definition may require some refinement in the legislation, generally speaking it would seem that a beneficiary who did not qualify under one or other of the tests suggested would have such a remote chance of obtaining the corpus that his tax rates should not be used in determining the amount of initial tax payable by the trust.

Where a prospective beneficiary was eligible to file an election it would be necessary for the trustee to report to him the amount of income accumulated for him. If the prospective beneficiary then filed the election, he would report to the trustee the amount of the additional tax which he, or his family unit, would pay if the trust income for the year which was not distributable in the year, but was accumulated, had been received by him. He would also file with the tax authorities a return showing his calculation of the additional tax. Most of this information would be derived from his regular income tax return or that of his family unit. The income of the trust for the year which was accumulated for him would be added to his regular income and the tax calculated. He should have the right to calculate the tax on a block averaging basis if he chose to do so, but not to assume that he had made any contribution to a Registered Retirement Income Plan or any deposit in an Income Adjustment Account unless he had actually made the contribution or deposit. The amount by which the tax so calculated exceeded his regular tax for the year would be the additional tax applicable to the trust income.

Where there were two or more prospective beneficiaries of a trust fund, the problem of arriving at an appropriate amount of initial tax would be more difficult. If their prospective interests were determinable, the income could be allocated among them in accordance with their interests for the purpose of permitting them to make elections and thereby to determine the amount of initial tax. If the interests of the prospective beneficiaries were not determinable, and there was a discretion as to which beneficiary would receive the fund, an election could be made only if all the beneficiaries

made the election, and each calculated the additional tax which would have been payable if he had received the entire amount of the trust income. The trust would then pay initial tax equal to the amount of tax that would have been paid by the prospective beneficiary who reported the highest additional tax. Where a fund was being accumulated partly for a prospective beneficiary and partly for a person who did not qualify as a prospective beneficiary, the initial rate would be reduced below 50 per cent only in respect of the part of the income which under the trust instrument could be identified as being accumulated for the prospective beneficiary.

In some cases, a gift or other income would be accumulated in trust for members of a class which consisted of infants and might include persons who were unborn at the time the trust received the income. For example, it might be payable to all the children of a specified person who were living at a particular date. In such cases, no prospective beneficiary of any particular part of the income could be identified, but it might be quite possible to identify with reasonable certainty the family unit or units to which the members of the class belonged, or would belong if all of them were born. In such a case it would seem reasonable to allow that family unit to be treated as a prospective beneficiary and to elect that the initial tax would be the additional tax which would have been payable by the family unit if it had received the income.

We recommend in Chapter 17 that where a taxpayer received a gift consisting of property other than cash or marketable securities, the donee should have the option to pay the tax on the gift in instalments over five or ten years with interest. This provision should also apply with respect to the initial tax which would be payable by the trust in similar circumstances.

Alternative Election

We have considered an alternative solution to the problem which would arise because the 50 per cent rate of tax would be higher than that applicable to most taxpayers and would involve an overpayment of tax. Under this alternative, the trust would pay tax at the top personal rate of 50 per cent on gifts or bequests, and interest on an assumed overpayment of tax would be payable by the government to the beneficiary who was entitled to the annual income from the gift or bequest (referred to below as the "income beneficiary"). In many cases, the chief person to suffer from the payment of tax at an unduly high rate would be the income beneficiary, because the payment of the excess tax on the gift would reduce the fund which produced income. The remainderman would recover the overpayment when the trust fund was distributed to him. The income beneficiary would be compensated for the loss of income by requiring the government to pay interest to him each year at the rate of, say, 5 per cent or 6 per cent on the excess of the initial 50 per cent tax over the tax which would have been payable if the initial gift had been taxed as part of the income beneficiary's comprehensive tax base.

This solution would not give complete or adequate relief in all cases. A formula based on an assumed inclusion of the entire trust fund in the income beneficiary's income would often produce an unduly high tax rate, and would unduly reduce the amount on which interest was payable. The entire compensation for the imposition of an excessive rate would be payable to the income beneficiary, while the remainderman would be deprived of the opportunity for the appreciation in the value of the property which was applied in paying the excessive tax. The procedure would involve an enforced "loan" to the government. It could not be used where all or part of the current income of the trust was accumulated and was not distributable to any beneficiary.

These considerations make it clear that this procedure would not be adequate to provide relief in all cases. However, it would be useful in the case of some discretionary trusts where no prospective beneficiary of the gift or bequest could be identified and accordingly there would otherwise be no relief from the imposition of initial tax at the 50 per cent rate. It might also be equitable in the case of some trusts which had prospective beneficiaries, but where the protection of the income beneficiary was considered most important.

Accordingly, we suggest that this procedure should be available as an alternative which could be elected only if no election had been made by a prospective beneficiary to pay initial tax on the gift or bequest at a rate lower than 50 per cent. It could be elected by income beneficiaries who were entitled each year to receive, or have applied for their benefit, all of the annual income arising from the gift or bequest as computed either for tax purposes or for trust purposes. If such an election was made, each income beneficiary would be required to file an appropriate return to establish the amount upon which he was entitled to receive interest.

Gifts Held in Trust for a Member of the Donor's Family Unit

We recommend in Chapters 10 and 17 that where a gift or inheritance was received by a member of the family unit of the donor, it should not be subject to tax. By the same token, we recommend that no initial tax should be payable on a gift or inheritance to be held in trust for the donor's spouse or another member of his family unit. This would be the case as long as either all the income from the given property, as determined either for tax purposes or under trust law, was payable annually to members of the family unit, or a member of the family unit was the prospective beneficiary of the property.

Where all the income from the property given was payable to a member of the family unit, it is reasonable that no tax should be payable on the

gift because the property would be used for the benefit of that member 5/. In view of the possible differences between the amount of income as determined for tax purposes, and the income as determined under trust law, it would be possible that an income beneficiary who was a member of the family unit would not be entitled to all of the income as determined for tax purposes. However, it would not be reasonable to impose tax on the property in these circumstances. Accordingly, we propose that no initial tax should be payable on the gift as long as one or more members of the donor's family unit received, or was entitled to receive, all of the income from the property as determined for tax purposes or all of the income as determined under trust law. The income beneficiaries would, of course, be subject to tax on the income from the property which was distributable to them.

If the prospective beneficiary of a gift was a member of the donor's family unit, the gift should likewise be free of initial tax, although income arising from the gift and property gains on the subject matter of the gift would not. If the donated property was ultimately distributed to that person while he was still a member of the family unit, the distribution would be tax free. Consistent with this treatment, the trust would not be treated as having made a disposition at fair market value at the date of the distribution.

If circumstances should change so that neither of the two conditions referred to above was present, the trust should be subject to initial tax on the donated property at that time. For example, if the prospective beneficiary was a dependent child, initial tax would become payable upon his ceasing to be a dependent child by attaining the age of twenty-one or otherwise.

Credit for Initial Tax at the Cumulative Average Rate

We have indicated that an amount distributed by a trust out of accumulated income should be included in the income of the recipient, unless

it represented a gift to a member of the family unit of the original donor. Any initial tax paid by the trust on the amount distributed would be deemed to have been paid on behalf of the beneficiary as a withholding tax and accordingly the amount payable by the trust to the beneficiary would be reduced by the amount of the initial tax applicable thereto. The amount to be included in income would be the amount received, grossed-up to include the initial tax paid by the trust. The beneficiary would then obtain a credit for the initial tax and, if this credit exceeded his own tax liability, he would be entitled to a refund.

One problem arises from the fact that the trust may have paid initial tax on different parts of the accumulated income at different rates. In some years, tax may have been paid at the 50 per cent rate. In other years, elections may have been made by a prospective beneficiary to pay an amount equal to the additional tax he would have paid had he received the income. The rate at which this additional tax was calculated may have varied in the different years in which elections were made. A prospective beneficiary may have died after some income was accumulated and may have been replaced by another prospective beneficiary. The variety of possible circumstances, and of rates of initial tax, leads to the necessity of some reasonably simple but equitable formula for determining the rate of initial tax which would be available as a credit to a beneficiary who received a distribution of accumulated income.

We recommend that the gross-up and credit to such a beneficiary should be based on the cumulative average rate of initial tax paid by the trust on its accumulated income. The cumulative average rate would be determined by calculating the total income of the trust, other than currently distributable income, which had been subject to initial tax, and dividing this amount by the total initial tax paid thereon. When a distribution was made to a beneficiary out of accumulated income, the grossed-up amount included in his income and the initial tax for which he would receive credit would not be considered in any subsequent calculations

of the cumulative average rate. It would be desirable for a trust to make this calculation year by year so that it would have a record of its accumulated income and of the initial tax it had paid on that income. No distinction would be made in this calculation between gifts and other income except that gifts accumulated for a prospective beneficiary who was a member of the donor's tax unit and which, therefore, would not have been subject to initial tax, would be kept in a separate account. If the initial tax paid had been unduly high or unduly low, this would be corrected when the distribution was made.

Tax Credits with Respect to Dividends and Other Income

Dividends from Canadian corporations would be included on a grossed-up basis in the income of a trust, as they would be if received by any other taxpayer. In computing the initial tax, the trust would receive credit for the tax paid by the corporation. If the initial tax was lower than the credit for corporation income tax the trust should receive a refund in the same manner as any other shareholder. This treatment of dividends received by a trust is the same in principle as the one we propose for dividends received by a corporation. The chief difference in practice is that the trust's initial rate may be lower than 50 per cent, and that it therefore may be entitled to a refund.

A trust may receive income of various kinds which had already been subject to either Canadian or foreign tax and for which an individual recipient would be entitled to a tax credit. This would include dividend income as indicated above, interest income which had been subject to a withholding tax, and income from foreign sources which had been subject to foreign tax.

If the income was distributable in the year in which it arose, and the income beneficiary elected that it be taxed in his hands directly, the trust would not be entitled to a refund but would report the amount

of the total tax credits to the income beneficiary. The income beneficiary would include these amounts in his income and would obtain credit for them against his tax.

If the income was accumulated, and the trust was subject to initial tax on the income, the trust would obtain the appropriate tax credits. If the credits exceeded the initial tax otherwise payable, the trust would be entitled to a refund of the excess. In computing the cumulative average rate of tax paid by the trust, the amount of the tax credits which had been applied in reducing the amount of initial tax payable would be deemed to have been paid by the trust as initial tax. In this way, the beneficiary would receive the appropriate credit when the accumulated income was ultimately distributed to him.

Losses

In our view, losses incurred by a trust should, as far as possible, be treated in the same manner as losses incurred by any other taxpayer. The treatment of property losses is discussed in Chapter 15 and the treatment of business losses is discussed in Chapter 22. However, in the case of a trust, certain special considerations have to be taken into account.

Where the income of a trust is payable to an income beneficiary and the trust fund will eventually be payable to a different beneficiary, any losses sustained by the trust will probably be borne by the remainderman rather than by the income beneficiary. However, under our proposals, the remainderman would not receive any immediate tax relief as a result of the losses. The losses would reduce the amount which he would ultimately receive from the trust and, in that way, would automatically be taken into account in computing the amount on which he was subject to tax. In the event that income was being accumulated in a trust, a loss incurred on the disposition of property or a business loss should be deductible from other income of the trust in the year of loss. It should also be available

to be carried back for two years and forward indefinitely for the purpose of computing the amount which was subject to initial tax in the hands of the trust. In this way, such losses would be treated in much the same manner as losses incurred by a corporation or any other taxpayer.

If a trust received property by way of a gift or bequest which was subject to initial tax on the fair market value, this value would be the cost basis of the property to the trust. If the property was subsequently disposed of for more than this amount, the trust would have a taxable gain, but if it was disposed of for less than this amount the trust would have a loss. Where property, which was specifically identified as the property which had been subject to initial tax as a gift, was disposed of at a loss, it should be provided that the loss could be carried back for more than two years so as to reduce the initial tax on the gift.

Losses incurred by a trust from the holding of property should be treated in the same manner as similar losses incurred by any other taxpayer. At the option of the trust, these losses could be carried forward against operating income from the same property, or could be reduced by the amount of certain expenditures, related to the property, which would be added to the cost basis of the property in the hands of the trust. On the disposition of the property, the cost basis would be relevant in determining the amount of the gain or loss.

We considered whether there was any method whereby losses could be attributed to the beneficiaries and applied against their other income. However, except in the case of unit holders' trusts (referred to later in this chapter) which elected to file returns as partnerships, we do not think that this would be appropriate. The losses would affect the amounts which were distributed to the beneficiaries and, in this way, would be taken into account in computing their incomes when the trust property was distributed.

Benefits

Under the present Income Tax Act, tax is imposed in respect of:

> "The value of all benefits (other than a distribution or payment of capital) to a taxpayer during a taxation year from or under a trust, estate, contract, arrangement or power of appointment, irrespective of when made or created...." 6/

Under this section, a beneficiary is taxable on all benefits he derives from a trust. Examples of such benefits are not common, but money spent by the trustee to maintain residential property occupied by a beneficiary is one. We recommend that this type of provision be maintained in order to prevent avoidance. The amounts expended by the trust to provide such benefits should be deductible in computing that trust income which was subject to initial tax, because these amounts would in effect be distributions.

Reversions

A reversion is an interest which will come back to the donor when a limited interest in the trust property terminates and there is no remainder or other interest to follow. Also, if a trust instrument provides for a gift of a remainder interest in certain events, and those events do not happen, in the absence of a further gift there will be a reversion to the settlor.

If a settlor gives property in trust to provide income to designated beneficiaries, but retains a reversionary interest in the trust fund, the trust property will probably be subject to estate tax on his death under the present law 7/. Furthermore, the income from the trust property will be treated as his income under the Income Tax Act, 8/ even though it is payable to another beneficiary.

Many reversions are only intended to provide a sensible alternative provision if the principal gift fails. The difficulty in separating those

reversions created for legitimate purposes and those created for tax avoidance has been set out as follows:

> "Contingencies of this nature may assume an infinite variety of shapes and forms to suit the need of the transferor. A stated contingency may represent a strong probability, and perhaps even a practical certainty, that the property will shortly return to the transferor. On the other hand, the possibility of regaining the property may be so remote as to be essentially non-existent. A general distinction might be made between contingencies which may reasonably be expected to occur and those which may not. Any such distinction, however, is too abstract to permit of efficient concrete application." 9/

Our proposals to pool the income of a family unit, to permit tax-free transfers within that unit, and to impose tax on a beneficiary outside the unit when he ultimately received a remainder interest would avoid many of the problems arising out of reversions under most tax systems. Most gifts involving reversionary interests are of a limited nature. The property would ordinarily be held in trust and the income would be paid to a beneficiary for his life or for a specified number of years. This beneficiary would properly be expected to pay tax on the income. If the property then reverted to the donor, the donee would only have paid tax on what he received 10/ .

We recommend that section 22(2) of the Income Tax Act which attributes the income of a trust to the settlor where there is a possibility of a reversion should be repealed. Under our proposals, the beneficiaries would pay tax on their interests in the trust fund and on the income from the fund. We consider this to be taxation according to ability to pay and therefore we do not recommend any special anti-avoidance provisions. Nevertheless, this is an area which should be kept under scrutiny to ascertain whether an unusual number of trusts, particularly inter vivos trusts with reversionary interests, were set up as a result of freer treatment of reversions and whether this resulted in any unfair avoidance of tax.

There is the further question of whether the donor who received a reversion of the property which he originally transferred to a trust should be taxed at all on the retransfer. We believe he should not, because no gift would have been made to another individual. The reason for not recognizing the retransfer in this case is both legal and equitable. Legally, there is no transfer on a true reversion; it is the intermediate interest which is considered as having been carved out of the entire interest. One may assume that reversions usually occur because of failures in the gifts intended and are thus not generally desired. Because there is no postponement of tax beyond the donor's power to postpone had he retained the property in his own hands, there is a good reason in equity not to levy tax on receipt of the reversion.

One exception to this treatment would arise if a reversion resulted from a renunciation or release by an intended donee after the expiration of the period of 90 days referred to later in this chapter. In this case, there would be a completed gift to the donee, and then a gift back to the original settlor.

If a donor made a gift to a trust so that, under the rules we have outlined, he would be an income beneficiary or a prospective beneficiary, the gift should be treated in the same way as if a member of the family unit of the donor was the prospective beneficiary. In this case, there would be no initial tax on the gift. However, if the terms of the trust were such that the donor was neither the income beneficiary nor a prospective beneficiary, the trust would be subject to initial tax on the normal basis.

If the property received by the donor on a reversion was the identical property which he transferred to the trust, he should receive the property at his original cost basis, and should not be regarded as having made any gain or loss. If the trust had paid initial tax on the gift, the

donor would receive credit for this tax and would be entitled to a refund.

If the property received by the donor on a reversion was not the property he originally donated to the trust, the trust may have incurred a gain or a loss on the disposal of the original property or on the disposal of subsequently acquired property. If there had been a gain, it would have been treated as accumulated income of the trust and would have been subject to initial tax. Upon receiving the property, the donor would include in his income the accumulated income grossed-up to include the initial tax, and would be entitled to credit for the initial tax in the same manner as if the property had been received by another member of his family unit. However, as in the case of a gift which was distributed to a member of the donor's family unit, the trust would not be considered to have disposed of the property at its fair market value at the time of the reversion.

Taxation of Specific Kinds of Gifts

In addition to preventing deferment of taxation on gifts generally, and particularly on gifts in trust, it is our object to achieve and preserve neutrality in the tax treatment of various kinds of gift. There is a great difference in people's ability to give in different forms and at different times. In general, as income and wealth increase, there is a greater flexibility in the mode and timing of gifts. There appears to be definite correlation between the size of estates and the use of trusts. The major assets of many people in the lower wealth groups are equities in their homes and consumer durables which cannot readily be given during the owner's lifetime. Lower income groups have little or no margin of surplus income which would permit them to adopt a programme of planned <u>inter vivos</u> giving. Under current law this is not so important because small estates are below the taxable level. Under our proposals, gifts from some small estates would be taxable in the hands of the donees,

and it is important that no significant tax advantage should be gained by the mode and timing of gifts. At the same time, we should like to stress that the various forms of gift serve well-recognized purposes, and we have no wish that the tax system should either encourage or discourage any particular form of gift.

In order to illustrate the way in which our proposals seek to achieve neutrality, we first describe the manner in which a direct gift would be taxed, and then deal with gifts in trust where distribution of the trust fund is deferred, including the very important case of a life tenancy with a remainder interest. Our proposed tax treatment of direct gifts payable in instalments, such as annuities, pension, and life insurance payments, is described in Chapter 17.

Gifts To Take Effect Immediately. A gift *inter vivos* is usually given directly to the donee unless the property is to be held by a trustee. It would be included in the donee's income immediately, unless he was a member of the donor's family unit. However, all testamentary gifts are held in trust by executors or administrators until distributed. Inheritances are ordinarily held by an executor, administrator or trustee until the assets are realized and debts and inheritance taxes are determined and paid. If there are trusts to be administered, then the trustee of the estate holds the property under the terms of those trusts.

Where property was to be distributable as soon as the administration was complete, the beneficiaries would be ascertained. The beneficiaries would include the amounts received in their incomes, and would be entitled to a credit for the initial tax unless an election was made that no initial tax was payable. Thus, a beneficiary receiving a direct gift or legacy would pay tax at his personal rate after taking advantage of the averaging provisions. His net position should be the same as a donee receiving a direct gift *inter vivos*, as discussed in Chapter 17.

<u>Annuities</u>. Our recommended tax treatment of gifts of annuities where the capital has been provided by the donor prior to death, either by outright purchase, or under pension or other plans, is described in Chapter 17. However, an annuity may be provided under a will or a trust. It may be payable out of current income or out of accumulations. An annuity paid out of a trust would be treated under our proposals in the same way as any other amount paid to an income beneficiary or a remainderman, as the case may be. The annuity would be included in the income of the annuitant when received. However, if the annuitant was a member of the donor's family unit, only the portion derived from income arising after the gift had been made to the trust would be subject to tax. Where the trust had paid an initial tax, the amount received by the annuitant, or the income portion in the case of a family unit member, would be grossed-up to include the initial tax and the annuitant would receive credit for the tax.

<u>Powers of Appointment and Encroachment</u>. An individual may be given a power under a trust instrument to encroach on property for his own benefit or to appoint the property to himself or others. There are many variations in the terms of such powers and the ways in which they can be exercised. We propose a rule in Chapter 17 for dealing with these powers: where an individual was given a power of appointment or a power of encroachment which would give him the right to apply property for his own use in his lifetime, he would be regarded as having received the property when the power became exercisable, unless he irrevocably renounced or released the power within 90 days after he became aware of it or after it became exercisable, whichever was later. The property would not be included in his income unless the power was exercisable by him alone without the concurrence of any other person. If his right to apply the property for his own use was not exercisable immediately, the property would not be included in his income until the power became exercisable.

The individual could avoid the receipt of income by renouncing the power at any time before it became exercisable, or within 90 days thereafter. If a person had a power of appointment but was not entitled to apply the property for his own use during his lifetime, the property would not be included in his income, but would be included in the income of the person in whose favour the power was exercised.

Under this rule, property would be considered as distributable to the person holding the power when he became entitled to apply it for his own use and benefit. If he was a member of the donor's family unit, he would not be subject to tax on any portion of the property which consisted of a gift from the donor, although he would be subject to tax upon any portion of the property which represented income arising after the date of the gift.

If trust property was treated as distributable to a person having a power of encroachment or a power of appointment, it should not be regarded as part of the trust property for tax purposes, but rather as property belonging to the person having the power. If, before the power was exercised, the property produced income, such income should be regarded as the income of the person having the power. If the income was paid to another beneficiary outside his family unit, it would be included in the other beneficiary's income as a gift. If the power was subsequently exercised in favour of some other person this would be treated as a gift by the person exercising the power to the person in whose favour it was exercised. If the power was not exercised there would, nevertheless, be a gift from the person having the power to the person taking the property under the trust instrument.

Renunciation or Release. Renunciation and release are very similar and reflect the fact that a person is not required to accept a gift. A person may renounce or release a gift. In the first case, there is no completed gift; in the second case, there is a completed gift, and the property will be transferred according to the terms of the original gift but will either

revert to the donor or will pass to some other person if provision has been made for this contingency in the original gift instrument.

The question which arises is whether such an act of release constitutes a transfer in itself or whether the transfer really springs from the original gift. In other words, should taxation be levied as if the person effecting the release had owned the property outright and had disposed of it by gift. The present Estate Tax Act makes a release a "disposition" in certain circumstances and therefore taxable as "property passing on death" 11/.

In our view, this question should be determined in accordance with the rule we have proposed for dealing with powers of appointment and of encroachment. If the terms of the instrument were such that the intended donee would be entitled to possession of the property for his own use, it should be regarded as distributable to him unless he renounced or released his rights within 90 days after he became aware of them or after his right to obtain possession arose, whichever was later. There should be no distinction in this regard between a renunciation and a release. If the intended donee renounced or released his right after the expiration of this period of 90 days, he should be regarded as having received the property and then given it to the person to whom the property reverted or passed, and tax would again be imposed on that person.

Remainder Interests. Because our proposals would require the trustee to pay an initial tax on amounts transferred to the trust, and would tax beneficiaries at personal rates on trust interests as they fell into possession, with credit for the initial tax, there would be no need to deal with contingent remainders differently from vested remainders. Both would be included in the beneficiary's income when distributed, unless excluded from income under the rules we have already discussed. This would achieve simplification of the rather complex provisions now required

for payment of estate taxes and succession duties on remainders or expectant interests. This rule would also apply to deferred gifts where there was no life or other income interest. We recommend that remainder interests, whether vested or contingent, and deferred interests of all kinds should be included in the tax base in the year in which the property was received. The beneficiary would gross-up the amount received at the initial rate of tax paid and would receive a credit at the same rate which would be deductible from his tax. If the credit exceeded his tax, he would be entitled to a refund.

In many cases, the widow or widower of the donor would be entitled to the income of the trust and no initial tax would be payable on the gift to the trust. On the death of the income beneficiary, the estate would probably be distributable, and would be taxed in the hands of adult children or other beneficiaries. However, it may not be immediately distributable and, accordingly, it should become subject to initial tax upon the death of the income beneficiary. However, if all or any part of the trust fund was distributable to a resident beneficiary in the year in which initial tax became payable, the trustee and the beneficiary should be entitled to file an election that the trust would not be subject to initial tax, and that the beneficiary would be subject to tax on the amount distributable to him.

Income-Splitting and
Attribution of Income

In the past, trusts have sometimes been used as vehicles for income-splitting and sections 21 and 22 of the Income Tax Act attribute to the settlor the income from property transferred by means of a trust to a spouse, to minors under 19, or to anyone if the settlor of the trust reserves benefits to himself.

Under our proposals, where property was transferred to a trustee, and the income beneficiaries were a spouse or minor children of the donor,

there would be no need for income attribution provisions because the income would be aggregated with that of the family. However, if the beneficiary of the income arising from the gift was a child who had opted out of the family unit or a spouse who had elected to file a separate return, the income might be taxable at a low rate. At the same time, if the donor or a member of his family unit was the prospective beneficiary of the gift itself, the gift would not be subject to tax. To prevent this possible abuse, we recommend that where property may revert to the settlor or a member of his family unit and the income from the property was payable to a dependent child who was eligible to be a member of his family unit but had filed a separate return, the income should not be taxed to the latter but rather to the settlor.

We have concluded that, except in this one case, we should not recommend special provisions to attribute income of short-term trusts to the settlor. Section 22(2) of the Income Tax Act now applies to all transfers in trust where the donor retains a right to have the property revert to him. Section 22(2) also attributes income to the settlor of property where he retains certain powers or benefits. It is our view that this provision should be repealed. If the settlor had an immediately exercisable power to reclaim the property it would be regarded as belonging to him under the provisions relating to powers of appointment and powers of encroachment. In this event, the income should be regarded as his income, and if it was distributed to someone else it would also be included in the income of that person as a gift. If the settlor did not have such a power, we do not think any provision would be necessary. However, this area should be kept under observation, and this conclusion should be reconsidered if a large number of trusts were created to reduce the applicable rates of tax on property income.

Multiple Trusts

Under the present law, an overall reduction in tax may be sought by creating a number of trusts and transferring the sum to be given equally to all the trusts—all of which have the same or similar beneficiaries. Each trustee pays tax as if each individual trust were a separate person and thus at a lower rate than if all the incomes were aggregated. Section 63(2) of the Income Tax Act seeks to prevent this by giving the Minister power to aggregate the income of one or more trusts where substantially all the property is received from one person and the trusts are for the same beneficiary or group of beneficiaries. However, this provision suffers from being both too broad and too narrow. It provides for the exercise of ministerial discretion, something which should be avoided where possible, and the conditions of application are too narrow to meet all the cases where avoidance may be in issue.

For three reasons, the opportunity to transfer income-producing property so that the income flowed to someone who was taxed at a lower rate than the transferor would be substantially lessened under our proposed system. First, under the family unit concept, the income of the members of a family would usually be aggregated rather than split. Second, a recipient of transferred property who was outside the donor's family unit would be taxed on the value of the property given to him. This would narrow the advantage of income-splitting. Third, the income of a trust would be taxable either at the top rate of 50 per cent or at the personal rate of the beneficiary or prospective beneficiary. If the beneficiary was entitled to income from a number of trusts, or if income was accumulating for him in a number of trusts, these would all be aggregated in determining the amount of additional tax which would be payable on the income as an alternative to tax at the 50 per cent rate.

For these reasons, under our proposals it should not be possible for rates of tax to be reduced by the use of multiple trusts. We believe that

the method of taxation of accumulated trust income that we propose would be of broader scope than section 63(2), and would avoid the use of ministerial discretion. Accordingly, no provision such as section 63(2) would be necessary.

Exempt Trusts

Under the present law, a trust is exempt from income tax in some circumstances. The trusts which are now exempt are charitable trusts and trusts established under registered retirement savings plans, pension plans, and certain other types of employee benefit plans. Generally speaking, we think that this treatment should be continued.

In Chapter 20 we discuss the proposed treatment of charitable trusts, and recommend their continued exemption from tax, subject to certain qualifications.

In Chapter 16 we discuss our proposed treatment of Registered Retirement Income Plans. If a trust was established to fund a Registered Retirement Income Plan, and the plan retained its registration, it should be free of tax. The beneficiary or beneficiaries would likewise be free of tax until they actually received benefits from the trust.

Exempt Beneficiaries

In some cases, the beneficiaries of a trust may include a charity or some other tax-exempt body. If current income was distributable to an exempt organization, that income would be free of tax, unless the income was from a business or an investment of a kind which would render it taxable under the rules discussed in Chapter 20. Similarly, if a gift was made in trust with a provision that all of the income as calculated for either tax purposes or trust purposes was payable to an exempt

organization, there should be no initial tax upon the gift until the income ceased to be so payable. This is consistent with the treatment which would be applicable if the income beneficiary was a member of the donor's family unit. Similarly, if an exempt organization was a prospective beneficiary of a gift or other income which was accumulated, that income should not be subject to initial tax. However, an exempt organization should only be regarded as a prospective beneficiary if the property was indefeasibly vested in it.

If an exempt organization had only a contingent interest in a trust fund, initial tax should be payable by the trust in the usual way. If property which had been subject to initial tax was received by the exempt organization, the organization would receive credit for the initial tax in the same way as any other taxpayer and would be entitled to a refund.

Business and Investment Trusts, Including
Unit Holders' Trusts

In this chapter we have referred mainly to trusts arising on death or created by an *inter vivos* gift for the benefit of the donor's family and other beneficiaries. Such a trust may carry on business or may derive its income from property. The basic method of taxing such trusts and their beneficiaries should be generally the same regardless of the source of income, except that a gift or bequest for the benefit of a member of the donor's family unit would be treated differently from other income.

Business income, as well as other income, should be taxed consistently, without regard to the form of organization earning the income. Our proposals for the taxation of trusts are analogous to those for the taxation of corporations and co-operatives, subject to the necessity of some differences in treatment to take account of the nature of the interests of trust beneficiaries. Income of a trust which was currently distributable would be subject to tax at the rate of 50 per cent, but a beneficiary to

whom such income was distributable could elect to pay tax at his personal rate, in which case the initial tax would not be payable. This election is analogous to an election that a corporation may be taxed as a partnership. Income accumulated by a trust would likewise be taxable at the 50 per cent rate, subject to the fact that in most circumstances a beneficiary would be entitled to make an election which would mitigate the burden of this tax.

While we have proposed that a corporation should be entitled to allocate its income to the shareholders who would then be entitled to refunds where applicable, we have not provided for a similar allocation to beneficiaries of trust income which was not distributable currently but was accumulated. The reason for this is that the interests of beneficiaries are often contingent or dependent upon future events so that it would often be impossible to make any appropriate allocation. Instead of providing for such an allocation, which would often lead to capricious results, we have provided for an election under which, in some circumstances, the trust would pay tax on accumulating income at a prospective beneficiary's rate rather than at 50 per cent.

Trusts are sometimes formed specifically for the purpose of carrying on a business, or for carrying out a project, or for the purpose of investment. Such a trust (which we refer to sometimes as "business trusts") is similar to a partnership, syndicate, or corporation. In Canada, business trusts have principally been used for investment, for example in mutual funds, and for joint investment in real estate by small groups. The legal nature of these trusts is discussed in Appendix C to this Volume.

There are distinctions between a business trust and a trust created by a donor for personal distribution of his property. The funds or property of a business trust are usually supplied by those who are the beneficiaries or unit holders and the powers of the trustee are tailored to their interests. In a personal trust, the donor and the beneficiaries

are usually different and the trust reflects the wishes of the donor rather than of the beneficiaries.

Interests in business trusts are often issued as "units" of the trust and these units are often transferable. Sometimes they are redeemable by the trust, often at the request of the unit holder. Units of this kind are analogous to shares of a corporation. Our general proposals for the taxation of property gains would require that any gains or losses realized on the disposal or redemption of a trust unit or of any other interest of a beneficiary in a trust should be taken into account in computing the income of the unit holder or other beneficiary. Also, any costs incurred in acquiring an interest in a trust would be deductible by the beneficiary on disposal or realization of that interest.

Where a trust has issued transferable or redeemable units, each of which carries a specific undivided interest in the trust property and the trust income, the trust should be taxed in the same manner as a corporation. This means that the trust would be subject to initial tax at the rate of 50 per cent unless it elected to be taxed as a partnership. Income distributed to the beneficiaries would be treated in the same manner as dividends. The beneficiaries would gross-up the distribution to include the initial tax and would be entitled to credit for the initial tax. We refer to this type of trust as a unit holders' trust.

A unit holders' trust should be entitled to allocate income even if the income was not distributed in the year. Such an allocation would operate in the same way as one made by a corporation. The unit holders would include the grossed-up amounts allocated to them in their incomes, and would be entitled to credit for the initial tax and to a refund where applicable. In addition, the amounts allocated to each unit holder would be added to the cost basis of his unit and in this way would be taken into account in computing the gain or loss realized by him on the disposal or redemption of the unit.

Where the circumstances were such that a corporation would be entitled to elect to be taxed as a partnership, a unit holders' trust would be entitled to make a similar election. If such an election was made, the trust would not pay an initial tax, but the income would be treated as having been earned by the unit holders. Similarly, if the trust should incur a business loss or a loss on disposal of property, the unit holders would be entitled to deduct their portions of the losses in computing their incomes.

Residence of Trusts

Residence has been the principal jurisdictional test for income tax in Canada. In the case of a trust, this test is sometimes difficult to apply. The best view seems to be that a trust has the same residence as the trustee. Although the residence of the controlling trustee is a factor from which the residence of the trust can clearly be determined in most cases, in some circumstances it can cause great difficulty. Thus, if there are two trustees in equal control, residing in different countries, is the trust to be regarded as resident in each country? Even more difficult would be a case of three trustees in three jurisdictions subject to a direction that the majority of the trustees govern. Theoretically, there could be a trust with any number of trustees in any number of countries. It is quite possible for an individual or a corporation to be resident in two or more countries at the same time. A corporation may have dual or multiple residence where its central management and control is divided between two or more jurisdictions. This is presumably also true in the case of a trust.

We have considered a number of other bases for jurisdiction over trusts but have decided that the test for jurisdiction should continue to be primarily the residence of the trustees. The definition of residence should, of course, be stated as precisely as possible to enable the taxing

jurisdiction to be readily determined. Therefore, without formulating a hard and fast rule, we suggest that a trust should be taxed as a Canadian resident in either of the following circumstances:

1. When the trustees, a majority of the trustees, or a controlling group of the trustees are resident or ordinarily resident in Canada.

2. When a trust carries on substantially all of its business in Canada or where substantially all of its property is situated in Canada.

All trust companies handling trust business in Canada must be incorporated either federally or provincially and therefore, under the present Act, they are regarded as resident in Canada if they are incorporated here 12/. Therefore, trusts with Canadian corporate trustees would be resident in Canada. It may be desirable, however, to exempt from Canadian jurisdiction trusts created by non-residents where it was principally the management abilities of Canadian trust companies which were sought. Accordingly, we recommend that a trust administered by a Canadian incorporated trustee should not be a resident of Canada for a taxation year, if the trust received substantially all of its property from a non-resident of Canada, all, or substantially all, of the assets were situated outside Canada, and all, or a majority, of the beneficiaries were non-residents.

We recognize that the residence test alone would not prevent avoidance, but we expect the fruits of avoidance to be denied by other measures which we propose to prevent leakage of tax revenue. These measures include withholding taxes on property income paid to non-residents, on gifts made to non-residents, and on property gains deemed to have been realized when a taxpayer ceased to be resident in Canada. Our specific recommendations for taxing payments from trusts to non-residents and payments to non-resident trusts are dealt with in Chapter 26 and later in this chapter.

We also recommend that where any of the beneficiaries of a non-resident trust were resident in Canada, the trust and the beneficiaries should be entitled to elect that the trust would be taxed as being resident in Canada. This is consistent with our view that a trust is an intermediary and that the persons bearing the tax are the beneficiaries. Such an election would permit the trust to pay initial tax on its income by reference to the rates of tax of the beneficiaries, where this was appropriate under our proposed rules. In making such an election, the trust would be required to file returns and to pay taxes as a Canadian resident, and to supply all information and records necessary for the assessment of its returns. It would also have to submit to the jurisdiction of the Canadian courts.

Change of Residence of Trust

It is possible that the residence of a trust may change, either because trustees change their residence or because of a change in trustees. The rules applicable where a resident trust became non-resident, or where a non-resident trust became resident, should be consistent with the rules applicable to changes in residence of other taxpayers. However, trusts present special problems, because their tax liability depends to some extent on the residence of the beneficiaries.

If a trust which was resident in Canada became non-resident, there should be a deemed realization at the fair market value of all trust property. This is the same rule that would apply to any taxpayer as explained in Chapter 15. If the beneficiaries were resident in Canada, the trust should also be required to pay sufficient additional tax on any accumulated income on which initial tax had been paid to bring the total initial tax up to 50 per cent of that income. These provisions which seem necessary to prevent tax avoidance, would not be unfair, because the trust could avoid the deemed realization and the additional tax by electing to continue to be taxed as a resident trust.

If a non-resident trust became resident in Canada, it would be entitled to have its property valued so as to establish a cost basis. This is the same right any other taxpayer would have on becoming a resident. If there were Canadian resident beneficiaries, the trust should be required to pay initial tax at the 50 per cent rate on accumulated income which would have been taxable if the trust had been resident, subject to the elections noted above in the case of property held for resident prospective beneficiaries. However, in computing this tax the trust should be entitled to credit for Canadian withholding tax paid on any income received from Canadian sources, and not previously distributed, and for foreign tax up to a maximum rate of 30 per cent on any undistributed income which it received from foreign sources. The trust, however, should not in any case be entitled to receive a refund as a result of these credits.

Income from Foreign Sources

Where a trust received income from foreign sources, it should be entitled to a credit for the foreign tax on that income. We recommend that this type of income should be taxed to a trust in the same manner as to a corporation or an individual, and that the credit should be so calculated 13/. Thus, the trust would be regarded as having paid the applicable foreign tax as part of the initial tax, so that the beneficiaries would obtain the appropriate credit on either the current income or the accumulated income distributed to them.

In the event that an election was filed under which income distributed currently was taxable in the hands of the beneficiaries, rather than subject to initial tax in the hands of the trust, the beneficiaries would be entitled to a tax credit in the same way as if they had received the income directly, except that all of the holdings of the trust in a foreign corporation would be taken into account in determining whether the income was from direct foreign investment. This is consistent with the treatment which would be accorded to a corporation which elected to be taxed as a partnership.

Payments to Non-Resident Beneficiaries

There is evidence that there has been substantial tax avoidance through the provisions relating to the payment of trust income to non-resident beneficiaries. Such payments were normally deductible in computing the trust income and were subject to withholding tax at the rate of 15 per cent. In 1965, section 63(4b) of the Income Tax Act was enacted to prevent this type of avoidance. Prior to the enactment of this provision, a resident trustee could carry on a business and pay the income to a non-resident beneficiary subject only to a 15 per cent withholding tax. In computing the income of the trust, the trustee could deduct the amount paid and thus pay no other tax. If the non-resident beneficiary was a corporation resident in a tax-haven country and its shares were owned by a Canadian corporation, it could declare a dividend to its Canadian parent which would be free of immediate tax under section 28(1)(d). Section 63(4b) now denies the deduction to the trustee where income from a business carried on in Canada is payable to non-residents and certain others. However, this provision does not prevent a similar type of avoidance in the case of investment income. Under our proposals, this type of tax avoidance would not be possible. In Chapter 26 we recommend the repeal of section 28(1)(d). We also recommend changes, outlined below, in the taxation of trust income paid to non-resident beneficiaries.

We propose that income of a trust, other than gifts or inheritances, should be taxed in much the same way as corporate income. If distributable to a non-resident, or accumulated for the benefit of a non-resident, it should be subject to initial tax at the rate of 50 per cent, except that income from direct foreign investment would be taxable at 30 per cent less the allowable foreign tax credit, which would be deemed to have been paid as initial tax. The initial tax would also, of course, be reduced by any credits to which the trust was entitled in respect of dividend

income from Canadian corporations. Upon payment being made to the non-resident, the recipient would not be entitled to any credit for the initial tax, and there would be a further withholding tax at the rate applicable to dividends. This would mean that most trust income, excluding gifts and income from direct foreign investment, would be taxable at a combined effective rate of 55 per cent or 57.5 per cent, that is, 50 per cent plus 10 per cent or 15 per cent of the remaining 50 per cent.

Where income of a trust was payable in the year to a non-resident, the combined effective rate of 55 per cent or 57.5 per cent might create hardship in some cases. If the non-resident had received interest or rental income directly rather than through a trust, the rate of tax would have been 30 per cent, or possibly less by reason of an international tax convention. If the non-resident received foreign income, no Canadian tax would be payable. However, if the non-resident received dividend income from a Canadian corporation, it would have been subject to a 50 per cent corporation income tax and the net amount payable would have been subject to a withholding tax of 10 per cent or 15 per cent, and accordingly the corporate income would have been subject to a combined effective rate of 55 per cent or 57.5 per cent. In order to avoid distorting the tax position of a non-resident by reason of the interposition of a trust, it should be provided that a non-resident who received income from a Canadian trust in the year it was earned, may elect that instead of the normal 50 per cent initial tax and the withholding tax, the income payable to him would be subject to the same withholding taxes which would have been payable if his allocable share of the income of the trust from each source had been paid to him directly. The initial tax would be applied against these withholding taxes and any excess would be refunded to the non-resident.

The same principle might be followed with respect to income accumulated for a prospective beneficiary who was a non-resident. If

such a prospective beneficiary filed the appropriate election, the initial tax would be adjusted to the amount of tax which would have been payable if the income accumulated for him had been paid to him.

The treatment of gifts and bequests also creates a problem, because a combined effective rate of 55 per cent or 57.5 per cent would be unduly high as applied to gifts and bequests to non-residents. We have recommended that gifts made to non-residents directly, and not through a trust, should be subject to initial tax at the rate of 30 per cent, assuming the donee was not a member of the donor's family unit. Accordingly, we propose that in the case of gifts or bequests which were distributable to a non-resident, or were accumulated for the benefit of a prospective beneficiary who was a non-resident, the initial rate should be 30 per cent. If a gift or bequest had been subject to an initial tax at 50 per cent because the beneficiary was unascertained, and if the gift or bequest subsequently became distributable to a non-resident, the tax should be adjusted to 30 per cent and the trust should obtain a refund. If initial tax had been paid at a rate lower than 30 per cent, upon the gift becoming distributable to a non-resident, the trust would pay sufficient additional tax to bring the total up to 30 per cent. The distribution would not be subject to any further withholding tax.

To the extent that a distribution was made out of accumulations which had accrued prior to the effective date of the legislation, it should be free of withholding tax, because distributions to non-residents out of the capital of a trust are not now subject to withholding tax. Such amounts may include gifts or bequests which have been subject to gift tax or estate tax under the present law, accumulated income which has been subject to income tax, or capital gains which under the present law have accumulated on a tax-free basis.

To apply the appropriate rates, it would be necessary to provide an

order of distribution. In the case of distributions to non-residents, the usual order of distribution discussed earlier in this chapter would have to be modified to distinguish between payments out of ordinary income of the trust and distributions of gifts received by the trust. We propose that where a fund consisted partly of gifts received after the effective date of the legislation and partly of other income earned after that date, distributions would be regarded as having been made first out of ordinary income and then out of gifts. If the trust had property on hand at the effective date, any remaining distributions would be considered to have been made out of that property.

Future Development of Trusts

Because trusts are often complex and are capable of infinite variety, the provisions we have suggested for dealing with them are necessarily complex. Under the present law, trusts have in many instances been complicated by the desire to minimize or avoid taxes. We think this would be less likely to occur under our proposals. The recognition of tax-free gifts to a member of the donor's family unit would eliminate the incentive to establish trusts in many cases. This should reduce the number of trusts which were established.

Most trust income now is distributed currently rather than accumulated. Our proposals should prevent the gaining of any income tax advantage from the accumulation of income, so that less income would likely be accumulated. New trusts would probably be designed in such a way as to facilitate allocations of income to income beneficiaries or prospective beneficiaries. Accordingly, there should be relatively few cases where hardship would result from the imposition of initial tax at a 50 per cent rate.

CONCLUSIONS AND RECOMMENDATIONS

1. A trust is an intermediary. It and its beneficiaries should therefore be taxed in a manner analogous to that applicable to corporations and co-operatives and their shareholders and members. Tax liability should be measured by the ability to pay of the beneficiaries rather than that of the trust, but provisions would be required to prevent deferment of the tax liability.

2. The income of a trust, calculated in the same way as the income of any other taxpayer and including gifts and bequests, should be subject to an initial tax for which the beneficiaries (other than non-residents) would receive credit. The initial tax would be at the top personal rate of 50 per cent, subject to the following special provisions:

   a) If the income consisted of a gift or bequest, as long as the prospective beneficiary was a member of the donor's family unit or all the income from the donated property as determined either for tax purposes or trust purposes was distributable to members of his family unit, no initial tax would be payable on the gift or bequest.

   b) A resident beneficiary, to whom income was distributable in the year in which it would be included in the income of the trust, would be entitled to elect that he, rather than the trust, would be subject to tax on that income. Where such an election was made the trust would not be entitled to a refund of tax in respect of dividend income, interest income, or foreign income which was distributable to the beneficiary who made the election, but that beneficiary would be entitled to a credit for his allocable portion of the amount.

c) If a gift was accumulated in a trust for a prospective beneficiary who was resident in Canada but was not a member of the donor's family unit, or if other income was accumulated in a trust for any prospective beneficiary who was resident in Canada, the prospective beneficiary could elect that the initial tax would not be at the rate of 50 per cent, but would be the amount of additional tax which would have been payable by the prospective beneficiary if he had received the income directly.

d) If a gift was accumulated in a trust for a prospective beneficiary who was not a member of the donor's family unit and no election was made under paragraph (c), or if a gift was accumulated in a trust in such circumstances that there was no prospective beneficiary, the initial tax would be at the rate of 50 per cent. But an income beneficiary who was entitled to all the annual income from the accumulation would be entitled to elect that he would receive interest from the government each year at the rate of, say, 5 per cent or 6 per cent on the amount by which the 50 per cent tax exceeded the additional tax which would have been payable if the initial gift which produced the income distributable to him had been taxed as part of his comprehensive tax base.

e) As is indicated in Chapter 26, the initial tax on income from direct foreign investment would be at the rate of 30 per cent rather than 50 per cent. This tax may be reduced by a foreign tax credit, but in that event initial tax would be deemed to have been paid at 30 per cent.

3. An individual would be a prospective beneficiary of an amount if it was indefeasibly vested in him or if he would be entitled under the

trust instrument to receive the amount, if he was living, not later than on the death of an income beneficiary who was older than he by at least ten years, or on his attaining a specified age not exceeding forty years, or on the later of these events if both conditions were applicable.

4. If specific property or a specific fund was required to be kept separate from other assets of a trust, the property or fund should be regarded as a separate trust for the purpose of calculating initial tax and for the purpose of determining the tax credit to which the beneficiary would be entitled.

5. Losses would be taken into account in computing the amount subject to initial tax on the same basis as in the case of any other taxpayer. If a trust received property by way of gift or bequest which was subject to initial tax at the fair market value, a loss incurred on the disposal of the specific property could be carried back for more than two years if necessary so as to reduce the initial tax.

6. When property was distributed to a beneficiary, the trust would be deemed to have disposed of the property at its fair market value and any resulting gain or loss would be taken into account in computing the initial tax, unless the property was a gift which was distributed to a member of the donor's family unit.

7. A beneficiary would include in his comprehensive tax base all amounts which became distributable to him from a trust in the year whether out of income or corpus. This would be subject to the following exceptions:

   a) A gift to the trust which was subsequently distributed to a member of the family unit of the donor would not be included in his income.

b) Amounts distributed out of trust assets on hand at the effective date of the legislation would be tax free. Property gains which had accrued in the trust up to the effective date would be free of tax to the same extent as similar gains of any other taxpayer.

8. Amounts distributable to beneficiaries in a year would be considered to have been paid out of trust assets in the following order:

   a) Out of income of the trust for the current year.
   b) Out of accumulations on which the trust had been subject to initial tax.

   c) Out of gifts which were free of initial tax because they were received for the benefit of a member of the donor's family unit.

   d) Out of property on hand at the effective date of the legislation.

9. The initial tax on any income would be deemed to have been paid by the trust on behalf of the beneficiary who ultimately became entitled to the income, in the same way as a withholding tax. Accordingly, the amount which he would be entitled to receive from the trust would be reduced by the amount of the initial tax deemed to have been paid thereon.

10. Where amounts were distributable to a resident beneficiary out of current income which had been subject to initial tax, the amounts included in the beneficiary's income would be grossed-up to include the initial tax thereon. He would receive credit for such initial tax and if it exceeded his tax otherwise payable he would be entitled to a refund of the excess.

11. Where amounts were distributable to a resident beneficiary out of

accumulated income of a trust which had been subject to initial tax, the amount included in the beneficiary's income would be grossed-up to include the initial tax thereon, and he would receive credit for such initial tax and a refund if applicable. The gross-up and credit would be based on the cumulative average rate of initial tax paid by the trust which would be determined by calculating the total accumulated income of the trust which had been subject to initial tax and by dividing this amount by the total initial tax paid thereon. This calculation would be made in each year in which distributions were made out of such accumulated income. The grossed-up amount of such distributions, and the initial tax for which beneficiaries received credit in the year, would be removed from consideration in making subsequent calculations of the cumulative average rate.

12. Benefits provided to a beneficiary otherwise than on a distribution would be included in the beneficiary's income.

13. If a donor was a beneficiary, he should be treated in the same way as a member of his family unit and the same consequences should follow. If property given by the donor reverted to him, he should not ordinarily be regarded as having made any gain or loss. If he received in return substituted property, he would be subject to tax on any gains made by the trust, but there would be no deemed disposal at fair market value by the trust when he received the property from the trust.

14. If an individual was given a power of appointment or a power of encroachment which would give him the right to apply property for his own use, he would be regarded as having received the property upon the power becoming exercisable, unless he irrevocably renounced or released the power within 90 days after he became aware of it, or after it became exercisable, whichever was the later. If he did not so renounce or release the power, and the property subsequently

passed to another person on the exercise of the power or under the trust instrument, he would be regarded as the donor of the property to the ultimate recipient. The income from the property would also be regarded as his income, and if it was paid to another person, it would be regarded as having been given by him to that person.

15. If an individual was a beneficiary under more than one trust, the income distributable to him or accumulating for his benefit under all the trusts should be taken into account in determining the additional tax payable under any election which he made. Because, under our proposals, it should not be possible to avoid or to defer tax or to split income through the use of multiple trusts, there would be no necessity for provisions such as sections 22(2) and 63(2) of the Income Tax Act. There would be an exception to this if the property may revert to the donor or a member of his family unit, and the income was distributable to a dependent child who was eligible to be a member of his family unit but had filed a separate return.

16. Where units were issued by a trust, any gains or losses realized on the disposal or redemption of a unit should be taken into account in computing the income of the unit holder. This would also be true in the event that an interest in a trust was disposed of by any beneficiary. If a beneficiary had incurred costs in acquiring an interest in a trust, they would be deductible in computing his gain or loss.

17. If a trust issued transferable or redeemable units, each of which carried a specific undivided interest in the trust property and the trust income, the trust and the unit holders should be taxed in the same manner as a corporation and its shareholders. Initial tax should be at the rate of 50 per cent, unless the trust elected to be taxed as a partnership. Unit holders would receive credit for the initial tax with respect to amounts distributed or allocated to them.

18. A trust should be taxed as a Canadian resident if a majority of the trustees or a controlling group of the trustees were resident in Canada, if the trust carried on business in Canada, or if substantially all of its property was situated in Canada. If any of the beneficiaries of a non-resident trust were resident in Canada, the trust and the beneficiaries would be entitled to elect that the trust would be taxed as being resident in Canada.

19. If a resident trust became non-resident, there should be a deemed realization at the fair market value of all trust property, and the trust should be required to pay sufficient additional tax on accumulated income to bring the total initial tax up to 50 per cent of that income.

20. If a non-resident trust became resident in Canada, the cost basis of its property would be the fair market value at that time. If the trust had Canadian resident beneficiaries, it should be required to pay initial tax at the 50 per cent rate on accumulated income, subject to credits for Canadian withholding tax and foreign tax previously paid.

21. Income distributable to non-resident beneficiaries, except income consisting of gifts or inheritances or income from direct foreign investment, would be subject to initial tax at the rate of 50 per cent, and the net amount distributed would be subject to a further withholding tax at the same rate as was applicable to dividends. However, the non-resident beneficiary or prospective beneficiary would be entitled to elect that instead of the 50 per cent initial tax and the withholding tax, the income payable to him would be subject to the same withholding tax as if it had been paid to him directly. Gifts and bequests which were distributable to non-resident beneficiaries would be subject to initial tax at the rate of 30 per cent, and would not be subject to any further withholding tax.

REFERENCES

1/ When the trustee has active duties to perform in managing the trust property, or has discretion over the manner in which income or the trust funds are to be distributed, the trust is known as an "active" trust. If the trustee is merely holding property for the beneficiary, he is known as a "bare" trustee, and any beneficiary of full legal capacity can require that the trust be terminated as far as he is concerned and the property (or his share of it) distributed to him.

2/ For example, a spouse or dependent child would not be taxable on gifts and bequests from the other spouse, and accordingly, gifts made to a trust in which members of the donor's family unit were the beneficiaries would not be subject to tax.

3/ Sections 21(1) and 22(1) dealing with gifts to a spouse and persons under 19, respectively, and section 22(2) dealing with trusts with retention of a benefit or rights.

4/ Section 63(2).

5/ This treatment would produce the desired neutrality with direct gifts, for the same tax result would be attained had the property been left directly to the member of the family unit and he in turn had later left it to the remainderman.

6/ Section 65(1).

7/ Estate Tax Act, sections 3(1)(d) and 3(1)(e).

8/ Section 22(2).

9/ Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax, Washington: United States Government Printing Office, 1947, p. 31.

10/ It is possible for an outright gift to be made subject to the possibility of a reversion under stated conditions. In this case, the original donee would be better off if he received the property in the form of an annuity or through a trust. Otherwise he would have to pay tax on the entire value of the gift without necessarily knowing how long he would retain it.

11/ Estate Tax Act, sections 3(1)(c) and 3(2)(b). The possible complexities of such determinations are well illustrated by the case of M.N.R. v. E.H. Smith and Montreal Trust Company, [1960] S.C.R. 477 where the Supreme Court divided 3-2 on the question whether, under the Dominion Succession Duty Act, R.S.C. 1952, Chapter 89, sections 3(1)(c) and 3(4), a disclaimer, made by a wife, of property received from her husband under Quebec law, was a fiduciary substitution, the exercise of a general power of appointment, or an *inter vivos* gift.

12/ Section 139(4a) of the Income Tax Act.

13/ This is discussed further in Chapter 26.

PART C

DETERMINATION OF BUSINESS INCOME

CHAPTER 22

GENERAL BUSINESS INCOME

We are concerned in this chapter with the measurement of business income. Individuals either own businesses directly as proprietors and partners, or own them indirectly by holding residual claims against intermediaries, such as corporations, co-operatives and trusts, that carry on business. We have already discussed the tax implications of carrying on business through these particular forms of intermediaries in Chapters 19, 20, and 21. The important conclusion was that the business income accruing to the benefit of an individual taxpayer should be measured by common standards regardless of the particular kind of business or the form of intermediary through which it passes. Therefore, in this chapter we are concerned with the determination of the income of a business without regard to the legal form under which it is conducted.

Succeeding chapters deal with the problems of measuring and taxing the business income of taxpayers in some industries that have unique characteristics. These are mining, petroleum, financial institutions (including life insurance), farming, forestry, fishing, general insurance, and construction. In seeking to resolve these problems our objective is to achieve neutrality in the treatment of business income arising from different kinds of businesses.

Although this chapter is concerned with the determination of business income, it is important to keep in mind that much of the significance attached to the source of income under the present legislation would disappear under our proposals. Of particular importance is the elimination of most of the tax consequences of the present distinction between income from business and income from property, a differentiation that is often difficult to make and has caused much of the uncertainty and inequity in the present tax system. Therefore, although it is useful for descriptive purposes to discuss our proposals as they apply to the various sources of income, we will suggest very few measures that are applicable to only one of the sources.

THE PRESENT SYSTEM IN GENERAL

Income from a business is brought into charge under sections 2 and 3 of the Income Tax Act, and section 4 provides that income from a business for a taxation year is the profit therefrom for the year. Section 139(1)(e) provides that business "includes a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade but does not include an office or employment".

The provision in section 4 that income from a business is the "profit" therefrom requires a determination of profit. That term is not defined in the Act but in practice the starting point for such determination is usually profit as established under recognized accounting practices 1/. Such practices must yield, however, both to express provisions of the Act and to decisions of the courts holding that in certain respects such practices are not applicable in the computation of income for tax purposes.

In calculating profit it is, of course, necessary to consider what is to be brought into income, when the income is to be brought into account, what expenditures are deductible and when such deductions can be made.

In determining what is to be brought into income, accretions to capital or property gains and other capital items are now excluded, in accordance with the established doctrine discussed in Chapter 9. There are also certain statutory exemptions which will be referred to later in this chapter.

Business income is ordinarily brought into account on the accrual basis, although farmers and members of professions may compute income on the cash method 2/.

The use of the word "profit" in the general definition of income from a business necessarily means that only net income is to be taxed, that is, gross revenue less the costs incurred in producing it. Such costs are, broadly speaking, of two kinds: those incurred in the day-to-day operation of the business, and an appropriate proportion of those costs incurred for the production (or preservation) of future revenue.

In determining whether particular expenses are deductible, account must be taken of recognized accounting practices, the express provisions of the Act and established legal doctrines. There are a number of provisions that limit the deductibility of certain expenditures. In Chapter 9 we discuss: section 12(1)(a) which prohibits the deduction of any outlay or expense except to the extent that it is made for the purpose of gaining or producing income; section 12(1)(b) which prohibits the deduction of capital expenditures or allowances for depreciation, obsolescence or depletion except to the extent that they are specifically permitted by the Act; section 12(1)(c) which prohibits the deduction of an outlay or expense if made to produce exempt income; section 12(1)(h) which prohibits the deduction of personal or living expenses of a taxpayer except for designated travelling expenses; and section 12(2) which prohibits a deduction in respect of an otherwise deductible expenditure except to the extent that it is reasonable in the circumstances.

The exclusion of capital receipts from income is based on legal decisions rather than any express provision of the legislation. The law contains a general prohibition against the deduction of capital expenditures 3/. Allowances for some capital expenditures, such as the cost of fixed assets, specified interest payments and certain costs of obtaining financing are expressly permitted 4/. Other capital expenditures, because the Act does not specifically permit their deduction, may not be deducted either currently or, because they do not fall within the capital cost allowance provisions, over a period of time, and are known for tax purposes as "nothings".

As to the timing of deductions, the ordinary rules of accrual or cash accounting, depending on the method followed by the taxpayer, will usually apply.

Income for the year is income from all sources, 5/ and a taxpayer is permitted to deduct a business loss from his other income in the year in which the loss was sustained. He may also carry business losses back one year and forward five years, but only against business income 6/. This is

subject to restrictions in the case of a corporate taxpayer if control of the corporation changes and the business in which the loss was incurred is discontinued 7/. The rule as to deduction of business losses from other income is subject to a limitation in the case of so-called "hobby farmers", as explained in Chapter 25 which deals in part with agriculture.

We also consider in this chapter the position of new and small businesses, which have a very important place in the Canadian economy.

Appraisal

We have reviewed briefly the present general rules for the taxation of business income relating to the revenues and gains which are brought into account, the expenditures and outlays which are deductible, and the time when the revenues and expenditures are taken into account. When viewed in the light of our comprehensive tax base it appears to us that the present rules are deficient in all three respects. Under our approach, all revenues and all expenditures must be taken into account in the computation of income and the principal problems remaining are those of timing.

The provisions of the present legislation with regard to the carry-over of business losses and their application against other income are in our opinion too restrictive, and we shall make suggestions as to ways in which they should be liberalized.

We have also considered the existing rules relating to the tax treatment of business transactions between persons who do not deal at arm's length, as in the case of parent and subsidiary companies. We think that these rules are inadequate and that more comprehensive regulation of such transactions is required.

MAIN PROBLEM AREAS

Application of Accounting Practices

We mentioned earlier in this chapter that under the present tax system the usual starting point for the determination of profit from a business is

the application of recognized accounting practices. We also pointed out that such practices are in some cases overridden by statutory provisions and legal decisions. The courts look to accounting practices in determining the meaning of profit, but have found that such practices are not always permissible for tax purposes.

The present statute does not expressly state that business income is to be computed according to recognized accounting practices. We have considered whether some such provision could now usefully be inserted in the tax legislation. Such a change might permit the elimination of a number of statutory rules and the simplification of the legislation generally. In Chapter 9 we pointed out that this same question was the subject of serious consideration at the time of the revision of the Canadian income tax legislation in 1948, and that it was then decided that the wide divergences in accounting practices were such that a provision of this kind was not practicable. The result was that the statute simply provided that income from a business was the "profit" therefrom.

In view of the many developments in the principles and practices of accountancy, we felt we should put to the accounting profession itself the question whether a specific reference in the legislation to accounting principles or practices would be desirable. The question was referred to a Special Tax Committee of the Canadian Institute of Chartered Accountants and referred by that Committee to the Institute's Accounting and Auditing Research Committee. In view of the importance of the matter, the full text of the reply of the latter Committee is given in Appendix A to this Volume. It states that the majority of the Committee reached the conclusion that a specific reference to accounting principles or practices in the income tax legislation would not be desirable.

We have concluded that the opinion expressed by the Canadian Institute of Chartered Accountants should prevail, and that the income tax legislation should not contain a provision prescribing the application of accounting principles and practices in the computation of profit. This conclusion does

not imply that accounting principles or practices are deficient, for indeed, we believe that recognized accounting practices should be taken into account, subject to the express provisions of the legislation and applicable court decisions as is now the case. Rather, it reflects our belief that the concept of income for tax purposes has unique characteristics which are frequently at variance with accounting concepts. In the detailed discussion below, we propose that some of the present statutory provisions affecting the computation of income from a business should be repealed, and we expect that if this were done the courts would look more to accounting and business practices in the future than they have in the past. However, in areas where these practices were not sufficiently precise for tax purposes some statutory rules would have to be used, and because such rules would doubtless have to cover many situations they might have to be arbitrary in order to avoid undue legislative complexity.

When we approached the Canadian Institute of Chartered Accountants, we were unable to tell them of the material changes in the computation of business income for tax purposes which the adoption of our comprehensive tax base would bring about. We believe it is unlikely, however, that the opinion they formed would be altered by our proposals.

Inclusions in the Tax Base

In determining the income of a business for tax purposes it is necessary at present to distinguish between gains of an income nature and those of a capital nature. Earlier in this Report we discussed the development of this concept in Canada and also summarized the treatment in the United States and United Kingdom. As far as a business is concerned, gains of an income nature are those arising in the ordinary course of the commercial activities which the business was formed to carry on, an obvious example being the revenue from the sale of inventory to customers. Gains of a capital nature may arise from the disposition of the business itself as a going concern or of all or part of what may be called the permanent structure of the business, an example being the gain on a disposition of the land,

buildings or equipment of the business. As such assets are regarded as capital assets, gains arising on their disposition are ordinarily regarded as accretions to capital and are not normally brought into income for tax purposes. In some of the legal decisions the distinction is drawn between receipts from the disposal of circulating capital, which are income, and those from the disposal of fixed capital, which normally are not.

There are some statutory exceptions to the rule that the proceeds of disposition of capital assets are not taxable. Under section 6(1)(j), amounts received which are dependent upon the use of, or production from, property are brought into income even if they are instalments of the sale price of property (other than agricultural land). This provision materially limits the forms in which a transaction may be cast without giving rise to tax liability by the vendors of properties such as patents, franchises and mineral rights. Under section 20, capital cost allowances taken on depreciable assets may be recaptured if the assets are sold for more than their undepreciated capital cost. On the sale of a business or part of a business, the consideration received for inventory must, under section 85E, be taken into account in determining income.

Other illustrations may readily be given of the distinction which has been drawn by the courts between gains of an income nature and gains of a capital nature. Thus, profits on foreign exchange will be taxable if they relate to inventory transactions, but not if they relate to the acquisition of capital assets. The proceeds of fire insurance will be treated as taxable if the property damaged or destroyed is circulating capital, but not if it is fixed capital (unless by way of recapture of depreciation). Compensation received for the failure of the other party to carry out a normal commercial contract will ordinarily be treated as income, but if the contract is one of major importance and forms part of the permanent structure of the business such compensation may be treated as capital. Government subsidies will be regarded as income if they are granted to supplement income, but as capital if their purpose is to assist in the acquisition of capital assets.

We have already referred to the difficulties under the existing system of determining whether a business is being carried on and whether particular income is from business or from property. Where it is plain that a business is being carried on, it may still frequently be difficult in practice to distinguish between gains of an income and those of a capital nature.

Because capital is invested in a business or property to gain an economic reward, we think it follows that any resulting gain of any kind should be taken into account in the determination of income for tax purposes. Accounting practices recognize that in the long run all revenue, as well as all expenditure, must be taken into account in measuring the income of a business. Because income is measured in annual periods, the main concern is to produce a record of annual earnings that indicates fairly the progress of the business. It is recognized that to a considerable extent the allocation of revenue and expenditure between annual periods is necessarily inexact, and that the inclusion in one year of miscellaneous amounts having to do with a different year is inevitable. The main concern of the accountant is to show such amounts separately if they would otherwise materially distort the income for the year concerned. But even though they are shown separately, they would usually be included in the calculation of total income for the year, and would certainly be included in arriving at income accumulated to date. On the sale of an asset, any costs applicable to it that have not been written off previously as an expense would be charged against the proceeds of the sale and, to the extent that such proceeds exceeded the unabsorbed cost, the excess would usually be regarded as income available for distribution.

Thus, the position under the present law is that a distinction of little significance to businessmen or accountants is of major importance for tax purposes. In the business world the question is not whether, but how or when, particular receipts or expenditures should be reflected in earnings. For tax purposes the segregation of capital and income items is now fundamental. This distinction is inequitable in our view, because any gain or loss changes the economic power of the taxpayer. In addition, the current tax treatment has

produced uncertainty and has given an exaggerated importance to the tax implications of many business transactions.

The present exemption of property gains from tax frequently leads to attempts to cast transactions in a form which minimizes tax. For example, on the sale of a business there may be considerable advantage to the purchaser, with no disadvantage to the vendor, if the consideration for goodwill is included in the price of a depreciable asset. As we shall see later in dealing with expenditures, there is also a significant anomaly within the tax system because the cost of developing a capital asset such as goodwill may be deductible, for example, the cost of advertising, whereas the proceeds of these assets when sold are non-taxable. The desire to realize non-taxable asset gains may also cause taxpayers to sell their businesses or business assets, rather than operate them to earn income that would be taxable.

At the present time, gifts received by a business are not ordinarily included in income for tax purposes. Cancellation of debt generally gives rise to income only when it is considered to be some kind of price rebate. Under the comprehensive tax base all such gains would be included in income. The implications of this change are discussed in Chapters 17, 18 and 20.

The comprehensive tax base that we recommend requires that all revenue be included in the tax base regardless of the way in which it arises or the source from which it comes. The adoption of this base would not only establish a common ground on which to measure the business income of all taxpayers but would also produce the following results:

1. Reduce uncertainty in the present tax system by removing the distinction between property gains and income.
2. Simplify the present legislation by permitting the elimination of provisions necessitated by such distinction.
3. Bring the tax treatment into closer touch with the realities of the business world and thereby reduce the effect of tax considerations on business transactions.

Timing of Revenue

The ideal method of determining the business income of all taxpayers would be to measure changes in economic power, including unrealized revenue. This approach would recognize that the creation of revenue is a gradual and continuous process, starting, for example, with the construction of production facilities and continuing through the development of a market, the taking of orders, the production of a commodity, and finally to the sale and delivery. Because all these steps are necessary in creating revenue, why should recognition of the revenue be delayed until the final moment of sale? We discuss in Chapter 8 the problems that would arise if income was recorded only when realized.

Completely objective measures of the potential revenue created at various stages in the process have not yet been developed, so that compromises are necessary. The determination of income is today a matter of recognizing revenue when the readily identifiable events of sale or disposition take place and of matching costs as accurately as is practicable against that revenue. In considering whether revenue should be recognized as arising at other times, it is important to bear in mind that objectivity, which is one of the prime considerations in accounting, is equally essential for tax purposes and therefore we cannot contemplate, at least for the present, a tax system based on rules less objective than those used in accounting.

Under accounting practice, revenue is not usually taken into account until goods or services have been provided to the customer and cash or a legal obligation convertible into cash has been received for them. Not infrequently, of course, amounts are received in advance of the provision of goods or services. Uncertainty as to the proper treatment of such amounts led to the enactment of section 85B of the Act, which deals in a comprehensive fashion with the timing of revenue. This section provides that "...every amount received in the year in the course of a business...that is on account of services not rendered or goods not delivered before the end of the year or that, for any other reason, may be regarded as not having been

earned in the year or a previous year" shall be included in income, but it also permits reserves to be established in respect of the portion of such amounts unearned during the year. The section also provides that (unless the taxpayer is on the cash basis) in computing income "...every amount receivable in respect of property sold or services rendered in the course of the business in the year shall be included notwithstanding that the amount is not receivable until a subsequent year...", and it permits certain reserves to be established in respect of amounts so receivable for property sold.

Because this section does not differ greatly from business practice and provides a legal framework within which to determine a taxpayer's liability, it may be thought to provide a satisfactory rule for tax purposes. We cannot, however, view the section with complete satisfaction. It is open to the objection that it requires amounts to be included in revenue that may not give rise to any net income at all, and the taxpayer is not assured that offsetting relief is afforded by the section. The provision, as it stands, is so complex that many of its implications are still not fully understood, even though it has been in the legislation since 1953. It is broad enough to deal with many of the situations which may arise in practice but there are still areas of uncertainty 8/. It appears to us that one of the key provisions that makes the section workable is that the reserves to be deducted must be reasonable, and yet this same test would be applied in any computation of profit according to recognized accounting practices. In their appearance at the public hearings of this Commission, representatives of the Canadian Institute of Chartered Accountants recommended the repeal of section 85B, subject to the retention of specific rules regarding instalment sales and the introduction of an allowance (which the section now denies) for guarantees, indemnities and warranties 9/. We agree with this proposal, because we have concluded that accounting and business practices have developed to a satisfactory degree.

Another problem with respect to the timing of revenue arises from the fact that, although revenue may be treated as realized when a sale is made

on credit, the receivable may turn out to be uncollectible. This possibility is recognized in the present legislation by paragraphs (e) and (f) of section 11(1) which permit, respectively, the deduction of a reasonable reserve for doubtful accounts and for accounts which turn out to be bad. In general, these provisions have proven satisfactory, although certain taxpayers have complained that the tax authorities place too much emphasis on an examination of specific accounts in determining what reserve is reasonable.

Under section 12(1)(e), no deduction of reserves is permissible in computing income unless such reserves are expressly provided for in the legislation. Apart from allowances for depreciation and depletion, this means that reserves for business generally are restricted to those permitted under sections 11(1)(e) and 85B. These provisions may have been necessary in the days when the businessman determined arbitrarily the amount set aside from profits for various purposes. However, we believe that the general prohibition of reserves has led to an over-emphasis by the tax authorities on the time at which revenues are recognized, and that in the present state of accounting and business practice such a provision is undesirable.

It also should be noted that the Canadian Institute of Chartered Accountants has recommended that the term "reserve" be applied only to a restricted number of items 10/. We suggest that in any future legislation the terminology suggested by the Institute should be taken into account.

In view of the foregoing considerations, we recommend the following:

1. The general disallowance of reserves should be deleted from the legislation.
2. The present specific provisions for reserves, namely, sections 85B and 11(1)(e), should also be repealed; with the result that the general statutory test of reasonableness would then apply to allowances for unearned income, to allowances for estimated losses in the value of accounts receivable, and to allowances in respect of the losses that could result from guarantees, indemnities and warranties.

3. In those cases where a test of reasonableness is difficult to apply and where it would be feasible to employ an arbitrary standard, the legislation should contain specific provisions with arbitrary rules to eliminate uncertainty. However, such rules should be framed so as to permit the most accurate estimate to be made of the average losses anticipated and should not make any allowance for contingencies. Thus, in Chapter 24, which deals with financial institutions, we recommend that specific arbitrary percentages should be established for the use of banks in valuing their loan accounts, and for all taxpayers in valuing real property mortgages receivable.

The implementation of these recommendations would be facilitated by consultations between the business and professional communities and the tax authorities, and we envisage that such consultations could take place through the informal advisory committees we recommend in Chapter 32.

This discussion concerning the timing of revenue for tax purposes has been in terms of the "accrual" basis of accounting, which we consider gives the best measurement of business income. The use for tax purposes of another common method of accounting referred to as the "cash" method is discussed later in this chapter.

Deductibility of Costs

Our affirmation of the general principle that all realized revenues of a business should be brought into income carries with it the further principle, to which we subscribe, that all reasonable business expenditures should be deductible at some time. However, we have also expressed support for the cardinal principle that in computing his taxable income no taxpayer should be permitted to deduct costs of a personal consumption nature. Thus, while we suggest that all costs related to the earning of income should be deductible at some time, we point out in Chapters 7 and 8 that expenditures which relate to personal enjoyment, use, or consumption cannot be allowed to reduce the comprehensive tax base. The problem in determining what costs

should be deductible is to ascertain whether an expenditure reasonably relates to the earning of income or is of a personal consumption nature. Most of the following discussion is concerned with establishing procedures for making this distinction in a feasible manner. We also consider the problem of determining the time at which a deductible expenditure should be allowed as a charge against income.

In Chapter 9 we discussed the deduction provisions contained in the present legislation, and the implications for these provisions of the adoption of the comprehensive tax base. We then suggested which sections of the Act could be eliminated and what general changes should be made in the remaining sections concerning the deductibility of expenditures. More important, we recommended that the sections remaining should be applicable to all income and should not be restricted in application to certain kinds of income. It is useful at this point to review the conclusions detailed in Chapter 9 and to point out their implications for the determination of income from a business. It is important to keep in mind that business income would continue to be determined for tax purposes in accordance with recognized accounting practices, but would be subject to the express provisions of the legislation and to any applicable legal decisions.

Section 12(1)(a) denies a deduction for an outlay or expense that was not made for the purpose of producing income. We believe that this limitation is unduly restrictive for there are expenditures, such as those which save costs, which may not be productive of income in a narrow sense but which should be allowed. Therefore, we suggest that the legislation should provide for the deduction of expenditures that are reasonably related to the gaining or producing of income. Such a provision should be expressed in wide, general terms.

Section 12(1)(b) provides that no deduction may be made in respect of capital expenditures or in respect of depreciation or depletion except as expressly permitted in the legislation. The general denial of a deduction of capital expenditures in computing income is simply another reflection of

the distinction between income and capital items for tax purposes which has existed in Canada since income tax legislation was first introduced. Accretions to capital have not been included in the computation of income, and expenditures for capital purposes have not been deductible. It is clear that the distinction between current and capital expenditures is frequently difficult to draw and has caused, and is continuing to cause, confusion and uncertainty among taxpayers and the tax authorities.

Some types of capital expenditure may qualify for capital cost allowance so that in some cases the question of whether an expenditure is a current or capital item simply affects the timing of the deduction. There are, however, a number of types of proper business expenditures, the so-called "nothings", which have been considered to be of a capital nature but for which no capital cost allowance is permitted. Examples of expenditures falling into this category include the cost of obtaining or terminating contracts of particular types, the cost of acquiring lists of customers, certain losses on advances to suppliers or customers, certain costs related to the issuance of securities, payments for goodwill, and certain expenditures for projects which are proposed but not consummated, for example, payments under options and architects' fees.

During our public hearings we received representations concerning the treatment of expenditures of this nature from a number of participants including the Canadian Bar Association and the Canadian Institute of Chartered Accountants. The 1965 amendments to the Income Tax Act provided relief in respect of a few such items. Under the comprehensive tax base all business expenditures would be allowable at some time, so that the problem would then become one of timing. Accordingly, we recommend that all expenditures that would be deductible under our test should be taken into account when incurred, unless they result in the acquisition of an asset which either falls within the definition of a specific capital cost allowance class, or is an asset, such as land or securities, which is not ordinarily expected to depreciate in value and the cost of which would be taken into account in computing the gain or loss when the asset was

disposed of. This would involve an extension of the present capital cost allowance system, and would mean that a particular business expenditure would be deductible when incurred unless it was the cost of an asset of the type referred to above or was an item that the legislation specifically required to be amortized over a period of time. Much of the present uncertainty would disappear, and the term "nothings" would become obsolete. This recommendation is discussed further in the next section on "Timing of Costs".

The deduction of expenditures for the purpose of producing exempt income is denied by section 12(1)(c). Under the comprehensive tax base, we anticipate that exempt income would be virtually eliminated, and that such a provision would cease to be necessary. We also propose that the present specific restrictions on the deduction of interest expense should be repealed.

Section 12(1)(h) denies a deduction for personal or living expenses except for certain travelling expenses. We have already emphasized that a very difficult and important distinction must be made between business and personal expenditures, for there can hardly be fair treatment of all taxpayers if some can charge personal expenses against taxable income and others cannot. The problem is broader than that already discussed in connection with employment income because it can also involve personal benefits provided to customers or suppliers of the business or to the owner of the business. In the last case, there is no natural constraint on the amount of the benefit because the payer and recipient are the same. We have already proposed a general rule that expenses be related in a general way to the earning of income. In addition, we recommend the retention of the present section 12(2) that limits deductions to an amount that is reasonable in the circumstances. We also agree that a provision is required to prohibit the deduction of expenditures that are of a personal nature. We have already discussed the current interpretation of section 12(1)(h) by the courts, and we have expressed the belief that, at least initially, it should continue to be left to the courts to establish the rules for border-line cases in this area. Some specific and arbitrary rules should, however, be included in the

Regulations to indicate the amounts to be deducted for specific kinds of expenditures where the uncertainty is great or where as a matter of policy a particular rule is to be adopted.

In Chapter 14, we suggested specific rules for travel and entertainment expenses, commuting expenses, club dues, etc. The guidelines we laid down there for identifying and valuing personal benefits should also apply to business income. The general approach for dealing with expenses that benefit employees should be applied to expenses that benefit customers, suppliers, or shareholders, that is, the expenditure involved should generally be deductible in determining the income of the business, and should be reported in the income of the individual who received the benefit. Failing such identification with the recipient, tax on a grossed-up basis at the top personal rate should be payable by the business whether or not the business was itself tax-exempt. The tax so paid by the business should be treated as an expense for tax purposes. Where the expenditure represented a gift conferred by an owner of the business, the amount thereof should be treated as income of the actual recipient, because it would represent a gift to him, and should also be taxed, on a grossed-up basis, to the owner of the business.

Section 12(2) denies the deduction of expenses to the extent that they are not reasonable in the circumstances. This provision, which has not been the subject of a great deal of litigation, permits the Department of National Revenue to disallow expenditures which could hardly be justified from a taxation point of view. Thus, it is a necessary part of the legislative measures that are required in order to differentiate between expenditures for the purpose of earning income and those that are of a personal nature. It is true that the test has given rise to some complaints because businessmen feel that they should be the best judge of what expenditures are reasonable for the purposes of their business, and we appreciate this point of view. However, it seems to us that this constraint on the principle that all business expenditures should be allowed is a fair one and should be retained. The question of reasonableness in particular circumstances would, of course,

continue to be left to the courts for ultimate determination in the event that the taxpayer and the tax authorities were unable to resolve a dispute.

Timing of Costs

If business income could be measured in terms of increments in economic power, whether realized or not, there would be no need to deal separately with expenditures. The result of operations would be shown by comparing the net change in economic power for any given period, thereby automatically allowing for both the incomings and the outgoings. Because it is not always possible to measure a change in economic power when it is not realized, and one is ordinarily forced to recognize revenue only when a transaction takes place, we have to deal separately with expenditures. Expenditures usually precede the realization of related revenue, so that the rules for measurement of business income must provide for the treatment of expenditures made in advance of the receipt of revenue.

One approach is often referred to as a process of matching costs against revenue. As we shall see in reviewing different types of costs, it is often difficult to identify specific costs with specific revenue, and, moreover, there is no certainty that any revenue will result from many types of expenditures.

Another approach is to treat expenditures as costs when incurred except when it is known they will bring future benefit. Under this approach, assets on a balance sheet, such as inventory and depreciable assets, can be viewed as residues of unabsorbed costs that are being carried forward against future periods.

Both these approaches raise the common problem that they require estimates to be made of the extent to which expenditures already made will produce a benefit in future periods. In other words, even though revenue is usually brought into account when realized, costs must frequently be carried forward beyond the period in which they were incurred. For this reason the treatment of costs is one of the most difficult problems in

accounting practice, and arbitrary rules may be necessary for tax purposes to provide certainty in the treatment of taxpayers in different businesses and to minimize differences in the treatment of their costs.

Inventory. The word "inventory" generally is used to describe goods which are purchased or manufactured for sale in the ordinary course of business. The purpose of inventory accounting is to bring certain costs into appropriate accounting periods. The determination of business income is then simply a matter of delaying the deduction of the costs of obtaining or creating the inventory until its sale. For a simple retailing operation in which goods are sold very soon after being purchased this is a fair statement, but for many business activities the matter is not simple. There are difficult problems in deciding which costs should not be written off as incurred but included in the inventory, and in determining by objective standards the extent to which the costs will benefit future periods 11/.

These difficulties are largely glossed over in the present provisions with respect to inventory valuation for tax purposes. Section 14(2) of the Act permits inventory to be valued at cost or market, whichever is lower, and section 1801 of the Regulations permits inventory to be valued all at cost or all at market. The terms "cost" and "market" are not defined. In practice, the various ways of determining "cost" and "market" under accounting methods are usually accepted, although there are some areas of dispute. For example, there may be difficulties regarding the amount of overhead to be included in cost, or regarding the valuation of second-hand items. In cases where the cost of inventory is written down to estimated market value, the tax authorities may contend that such an adjustment constitutes a "reserve" that is not allowed by the legislation.

It is evident that the rules regarding inventory valuation in the present legislation reflect the variety of methods used in practice, but they do little to help with the real problems, and should be removed. At the same time complex legislation would be necessary to provide satisfactory rules to ensure that taxpayers with businesses in different circumstances

would be treated fairly. Because the tax authorities are concerned with the degree of variation in inventory valuation found in businesses in similar circumstances, we considered the desirability of simple specific rules to ensure a minimum common standard in measuring business income. For example, one such rule would be to require that all businesses include in inventory the costs of the estimated variable and fixed overhead applicable to their inventory. We concluded, however, that specific rules should be introduced only if, after consultation between the tax authorities and the business and professional communities, there was little consensus on acceptable methods of valuation, and if the courts' interpretation of the word "profit" did not produce a satisfactory result.

Once the amount of cost embodied in an inventory has been determined, there remains the problem of matching that cost against the proceeds of sale. Such identification is often physically impossible, and a common assumption is that the items first purchased or manufactured are those which are first sold (first-in-first-out method), or alternatively that the cost of an item sold is represented by the average cost of items on hand at the time of the sale. In a period of rising prices the matching of costs in order of purchase or manufacture against the current selling price will result in higher recorded profits than with the average cost method. Conversely, in a period of falling prices, the recorded profits would be lower under the first-in-first-out method. Use of the average cost method accelerates the rate at which the recorded costs change after prices have risen or fallen. Another assumption used in certain businesses is that the last items of inventory purchased are sold first (last-in-first-out method). The emphasis in the last-in-first-out method is entirely on matching changing costs with revenues.

The present legislation offers no guidance on the appropriate method of matching costs of inventory against revenue. In the well-known Anaconda case 12/, however, it was held that this is one area where a practice that was acceptable for accounting and commercial use was not always acceptable for

tax purposes. The Supreme Court of Canada found that the last-in-first-out method of inventory valuation was an acceptable accounting method of determining profit for tax purposes in the circumstances of the particular business 13/. However, the Privy Council reversed this decision on the grounds that while the method might be acceptable for accounting or commercial purposes, it was not acceptable for tax purposes because, on the assumptions made, it disregarded ascertainable physical facts relating to the value of the remaining inventory, and permitted an increase in inventory values to be free of tax in a period of rising prices, and so was not appropriate to a tax system which measured income on a year-to-year basis 12/.

In this context, we believe that the tax purpose is at variance with the accounting purpose. Under the accounting purpose we can see that in certain circumstances there is some validity in using the last-in-first-out method of inventory valuation in measuring the annual income of a business as a going concern. Although accountants are somewhat concerned about the balance sheet inventory value that may result from this procedure, many accountants regard balance sheet considerations as secondary to those of the income statement. For tax purposes, we are of the opinion that the cost figure attributed to inventory on hand should be close to its most recent cost, and that the first-in-first-out method is generally preferable.

Although we have this important reservation about the use of the last-in-first-out method of inventory valuation for tax purposes, we recognize that in those circumstances where it is particularly appropriate, taxation based on other methods may cause a strain on cash resources for temporary periods. We have therefore given careful consideration to whether a means could be found to permit limited use of the last-in-first-out method for tax purposes, which would prevent it from being used as a protection against inflation and yet at the same time meet the requirements of these taxpayers. Such an approach would mean that the inventory value could not depart materially from current market value. If market values rose above cost as calculated under the last-in-first-out method, the inventory value should

be adjusted upwards so that it was no less than, say, 80 per cent of the average market value of the past three years, including the current year. If, on the other hand, market values fell below cost and the inventory value was therefore written down to market, it should be adjusted upward by any subsequent market recovery until its original cost value was reached. After that point, inventory values would be adjusted above cost only when cost was less than 80 per cent of average market value as already stated. In addition, we believe that any such provision should be limited to those industries where this method of inventory valuation is suitable to the circumstances of the industry and is actually used by businesses in their financial statements. As noted in the Exchequer Court decision in the Anaconda case, 14/ the last-in-first-out method is appropriate in circumstances where the sale price of the finished product closely reflects the current replacement cost of the materials content of the finished product, the inventory is large with a slow rate of turn-over, and the company does not speculate or trade in its materials. With these restrictions, it seems to us that only those taxpayers to whom the last-in-first-out method was particularly suited would make use of the provision, and that at the same time it would be useful to them. We have also given consideration to the economic implications of this method of inventory valuation. As we have already indicated in the discussion on economic stability in Chapter 3, investment in inventories is a source of short-run instability. Because the last-in-first-out method of inventory valuation tends to reduce profits in periods of rising prices, and to increase profits in periods of falling prices, its use might tend to stabilize business decisions. On the other hand, it would reduce the funds diverted to taxation in periods of upswing and would increase the diversion of funds in times of downswing with a destabilizing effect on the supply of funds to business.

In view of these considerations, we recommend that those businesses for whom the last-in-first-out method of inventory valuation is suited (as above set out) should be permitted to use that method, provided that they use it for their financial reporting and that, for tax purposes, the value

attributed to the inventory should not be permitted to fall below 80 per cent of the average market value. With the exception of these rules concerning the last-in-first-out method, we think that the valuation of inventories should not be subject to legislative rules.

Depreciable Assets. We now consider the timing of the deduction for expenditures on certain assets, such as buildings and equipment, which are useful over long periods and are commonly referred to as depreciable assets.

For tax purposes the most equitable method of deducting costs of depreciable assets would be one which matched the cost of such assets against the income arising from their use. Obviously to do this before their useful life had in fact expired would not be a simple task, because useful life might vary from one year to many years, and productivity would change from year to year. Yet, if the business income of all taxpayers is to be measured on the same basis, allowance must be made for these costs in a way which produces a reasonably accurate statement of income from year to year.

Under the Income War Tax Act depreciation on a straight-line basis was permitted on tangible assets, but only at the discretion of the Minister. Depreciation was considered to be essentially an allowance for wear and tear, so that it could apply only to tangible assets actually in use, and did not take into account the diminishing value due to obsolescence. There was dissatisfaction with the system because no official rates were ever published, and a taxpayer could never know whether he was receiving the same allowance as his competitors in the same business. Profits or losses on disposal of depreciable assets were considered capital in nature and were not taxable or deductible.

When the Income War Tax Act was replaced in 1948, and ministerial discretion was almost completely abandoned, "depreciation" gave way to the "capital cost allowance" concept for the amortization of the cost of assets. At the same time the allowance was extended to include certain intangible assets such as leasehold improvements, patents and certain franchises or concessions

for limited periods. Provision was also made on sale of assets for "recapture" of any excess capital cost allowance recovered through the sale. The use of the diminishing balance method, with its greater allowances in earlier years, in effect gave recognition, though in an indirect way, to obsolescence.

Under the present system the taxpayer has a statutory right to capital cost allowances. For simplicity, the so-called depreciable assets are grouped in the Regulations into a relatively small number of classes, for each of which a rate is prescribed. The maximum annual allowance is determined by applying the class rate to the unclaimed capital cost, that is, cost less capital cost allowance previously claimed, of assets in the class. Typical rates are 20 per cent for machinery and equipment, 5 per cent for buildings of concrete or steel construction, and 30 per cent for automobiles. When an asset is disposed of, the proceeds are deducted from the unclaimed costs of the class, thereby reducing allowances to be claimed in the future, or to the extent they exceed the unclaimed balance in the class, taken directly into income. Should the proceeds on disposal exceed the original cost of the particular asset concerned, such excess is not taxable. Taxpayers may claim capital cost allowance as soon as they own a particular asset, regardless of when it is put into use or whether construction is complete, and they have the privilege of claiming whatever amount of capital cost allowance they wish up to the maximum amount computed by using the specified rate.

Submissions to the Commission indicate that the present system has served its purposes well and has operated to the satisfaction of taxpayers. However, we think it pertinent to ask how closely it has enabled costs to be matched against resulting revenue, and whether it has placed the measurement of business income on as fair a basis as possible.

For guidance in this matter, we looked to the practice followed by business management in reporting income from operations. In a confidential survey of a number of corporations conducted by our research staff, it was found that most large business firms did not use the diminishing balance method of depreciation in their accounts. For the years 1955 to 1962, during which

time the 113 corporations surveyed accounted for 25 per cent to 30 per cent of the total capital expenditures of all corporations in Canada, capital cost allowances claimed exceeded depreciation recorded in the accounts of the corporations by approximately $1,200 million. The total deferment of tax resulting from these additional allowances is estimated to be almost $600 million and, when added to the deferred taxes of about $100 million recorded prior to 1955, a total cumulative deferment of tax of approximately $700 million to the end of 1962 results. These figures support the conclusion that the charges permitted under the present capital cost allowance system are, at least in the early years, in excess of what, in the view of management, is reasonably required to measure "actual depreciation".

Because the allowances under the present system appear to be generous in relation to a basis of determining business income that was free of tax considerations, we considered whether more reliance should be placed on accounting and business measurement of depreciation in order to reflect more accurately the individual circumstances of each business and thereby to achieve greater equity. However, we found that the accounting profession itself readily acknowledged that any particular method of depreciation was at best an estimate, and that it laid primary emphasis on some reasonable method of amortizing cost which would be adopted and applied consistently. Thus, an amortization of equal annual amounts over an estimated lifetime, the "straight-line" method, may be just as acceptable as a method under which the annual amounts continually diminish, as under the "diminishing balance" method. It therefore appears to us that reliance on accounting methods in this area would produce uncertainty, and would also have an unfortunate effect on business practices because the depreciation methods adopted would probably be adjusted to achieve the maximum tax advantage 15/.

We have therefore concluded that because of the uncertainty that could result from an attempt to match, on an annual basis, the costs of depreciable assets against resulting revenue, the use of simple and arbitrary tax rules is preferable. While such rules are unlikely to reflect accurately the annual loss in value of the assets, they at least ensure a minimum common standard

available to all taxpayers, and the ultimate allowance of all cost provides for a final reckoning. Liberal allowances are probably inherent in any simple system, and the present rates therefore appear generally to be satisfactory 16/. As we suggest in Chapter 4, a degree of liberality here can be accepted because it would probably assist in economic growth.

We therefore recommend that the basic system of capital cost allowances for depreciable assets and the general level of rates remain unchanged 17/.

Although the basic system of capital cost allowances is satisfactory, some technical modifications should be made in its structure. We comment on the more important of these below. Comments on other specific features of the system are contained in a separate study 18/.

As we have already noted, the present system permits a deduction to be claimed for assets even before they are put into use. This conflicts with the principle of matching costs against revenue, which we believe should govern. Therefore, we recommend that this feature should be deleted from the basic capital cost allowance system.

The permissive nature of the capital cost allowance system is such that the taxpayer is not required to claim any allowance if he does not wish to do so. This again is a departure from a measurement of business income that is free of tax considerations and has had undesirable side effects, the nature of which will become evident in the later discussions concerning business losses and incentives such as the three-year exemption for new mines. It would thus appear that some capital cost allowance should be required to be charged in arriving at a satisfactory measurement of business income. Because the rates under the present system tend to be on the liberal side, any mandatory deduction of capital cost allowances could hardly exceed 50 per cent of the permitted rates in any taxation year. The undesirable effects of the permissive nature of the capital cost allowances are, however, considerably reduced because of our recommendations for the more liberal treatment of losses and for the elimination of tax incentives in the form of

exemptions of certain income from taxation. Accordingly, we do not think the legislative complexity and record keeping which would be involved in requiring a deduction of capital cost allowance is warranted.

Under the present capital cost allowance system, proceeds in excess of the original cost of an asset are not taxable. In accordance with our proposals for a comprehensive tax base, the excess should be included in income. Generally, the excess should be taken directly into income, and should not be credited to the class in which the asset was included. To avoid compliance problems on small dispositions, taxpayers might be permitted to credit to the asset class any proceeds of less than, say, $5,000 from bona fide separate disposals, regardless of the original cost of such disposals.

At present, a terminal profit on disposal of all assets in a class can, on election, be taxed under section 43 as though it had been received over the five years ending in the year of disposal. No similar provision exists for terminal losses. In view of the expansion of the loss carry-over provisions and the averaging provisions which we recommend elsewhere, this special provision in respect of terminal profits on disposal of depreciable assets would no longer appear to be necessary. However, the present practice of deducting the amount of the proceeds of disposition of an asset, up to the amount of its capital cost, from the balance in its capital cost allowance class should be continued. This would appear to be a simpler procedure and, where gains arise, more favourable to the taxpayer than the alternative of computing the undepreciated capital cost of the assets sold, deducting this amount from the balance in the class, and using this figure as the cost basis in computing the taxable property gain.

The unclaimed cost of assets in a particular class cannot at present be deducted until all assets in the class have been disposed of. In certain cases, 19/ the rates of capital cost allowance may tend to be inadequate and there can be times when the unclaimed cost in any class may considerably exceed the original cost of the assets still on hand. We therefore recommend adoption of the suggestion made by the Canadian Institute of Chartered

Accountants that there should be a provision for an interim claiming of a terminal loss to the extent that the unclaimed cost in any class exceeded the original cost of the remaining assets.

The subject of capital cost allowance cannot be closed without considering leasing arrangements under which the lessee has some right to acquire the property. By renting a long-term asset instead of owning it, a taxpayer may enjoy most benefits of ownership and yet obtain a faster deduction of its cost for tax purposes in the form of rent than he would have obtained in the form of capital cost allowance had he owned the asset. If the lessor is subject to all the normal requirements of the capital cost allowance system in respect of the asset, this arrangement need not be of particular concern to the tax authorities. If, however, the lessor is able to accelerate the deduction of the cost of the asset, either by way of terminal loss upon disposal of the fixed asset, or as an inventory loss upon transfer of title to the lessee, the net effect is to achieve a faster write-off of the long-term asset and thereby to defeat the purpose of the capital cost allowance system.

Prior to 1963, there were provisions in a previous section 18 of the Act which were intended to prevent lessees under lease-option agreements from obtaining faster write-offs on capital assets covered by such agreements than would have been available if they had been purchased outright. In effect, the provision treated such agreements as agreements for sale of such assets, and treated payments thereunder as payments on account of the purchase price rather than as rental payments for the use of the property. The lessee's deductions from income in respect of such payments were limited to the equivalent of the capital cost allowances on the portion of the purchase price attributable to depreciable property. However, many shortcomings remained in the section despite various amendments and it was finally repealed in 1963. 20/

While the leasing business is based primarily on financial, rather than taxation, considerations, once a leasing arrangement is contemplated there is

an opportunity to obtain tax advantages. With the widespread use of leasing today, the treatment of such arrangements for tax purposes is a matter therefore of great concern if the capital cost allowance system is not to be undermined. In reviewing the problem, we realized that, with the great variety of terms on which leasing arrangements can be drawn, it would be impossible, as was found under the repealed provision, to provide detailed legislative rules to deal with the situation. This would be particularly true if the rules were based on possible events to take place in the future. At the same time, we believe that some specific provisions are required to control the tax postponement possibilities under this type of arrangement.

We recommend that a specific provision should be introduced into the legislation to allow deduction for rentals of long-term assets that the lessee has a right to acquire only to the extent that they are reasonable and that any excess be treated when paid as being on account of the purchase price of the asset. If the asset was a depreciable asset, this excess would be eligible for capital cost allowance when the asset was acquired, or would be deductible if the option lapsed. We also recommend that it should be specifically provided that where a lessee acquired, at less than its fair market value at the time of acquisition, an asset which he had been renting, such deficiency in the purchase price should be regarded as a reduction of rents previously claimed, except to the extent of the rents disallowed under the first part of our proposal, and the amount thereof should be brought into income immediately with an offsetting amount to be amortized in the future under the capital cost allowance regulations 21/.

"Nothings". There are certain expenditures that may be made for the long-run benefit of a business that are not now deductible for tax purposes as current expenses, and are not provided for in the capital cost allowance regulations. These are often referred to as "nothings".

The equitable treatment of business income requires that these expenditures should be allowed at some time. The problem of estimating the period over which benefits will result from the expenditures is, however, even more

difficult than in the case of depreciable assets. Evidence of this difficulty is seen in accounting practice under which costs incurred by a business in developing future markets are usually treated as current expenditures, and yet in special circumstances may be deferred 22/. Current write-off is usually recognized in practice by the tax authorities even though this treatment may be questionable. If, however, an item such as goodwill is purchased from another business its cost is disallowed as being of a capital nature, and no allowance is available either in the form of amortization of the cost over a period of years or as a final write-off when the goodwill no longer exists.

The most difficult of the "nothings" to deal with is goodwill. It is usually measured as the difference between the total value of a business as a going concern, equal to the expected annual level of earnings capitalized at the desired rate of return, and the value of its assets. The factors that might contribute to the creation of goodwill of a business are a particularly capable staff, established relationships with customers, "know-how" (including secret processes and technical data), a well-known company or product name with a good reputation, a franchise of indefinite life, or a special location. Some of these factors can be built up through good recruitment and training programmes, advertising campaigns, scientific research, or market research. The relative importance of the various factors is difficult to determine and will vary from one situation to another.

If income could be measured by changes in economic power, whether realized or not, then the goodwill arising because of certain expenditures incurred or actions taken would automatically be brought into account and there would be consistent treatment for all taxpayers. However, we have concluded that the measurement of income on the basis of the annual change in economic power would be generally impracticable, and we must deal with goodwill in the same manner as other factors contributing to business income, that is, recognizing revenue from it when realized and, in principle, deducting expenditures as incurred except to the extent that they benefit future periods.

In a continuing business it is almost impossible to identify the extent to which expenditures such as staff training, advertising, market research, and product development will benefit future periods. In practice, such expenditures are usually written off as incurred, both for purposes of the financial statements and under present tax treatment. It seems to us that this rather liberal treatment should continue, both as a practical matter and on the ground that it may have some economic advantages to the extent that it operates as an incentive to research and product development.

Where the ownership of a business changes, and part of the purchase price is for goodwill, the situation is different because a value has been placed on the goodwill factor as a result of bargaining between independent parties. Under the comprehensive tax base the proceeds of a disposition of goodwill would be subject to tax. There are arguments for permitting the purchaser some amortization of this value for tax purposes. The earning potential represented by the goodwill and created by the former owner will gradually disappear unless maintained by the new owner. It may therefore be reasonable to amortize this cost, while also permitting immediate deduction of the costs of maintenance under the new owner. An incidental effect of such a treatment would be to simplify some of the tax considerations in business take-overs, because it would mean that there would be few tax implications involved in the allocation of the purchase price between goodwill and other intangible assets of an indefinite life, which are not depreciable, on the one hand, and the tangible assets and intangible assets of limited life, the cost of which can be amortized, on the other.

To allow the amortization of purchased goodwill would be liberal because the value of goodwill generally does not depreciate. While immediate deduction of the costs of developing goodwill may be a necessary departure from an ideal tax system, the amortization of purchased goodwill would not be a necessary part of such a procedure, particularly as an independent value would have been placed on the goodwill. Furthermore, the costs to the new owner of maintaining or increasing the goodwill would still be deductible

when incurred. More important, if the purchased goodwill did in fact later decline in value or was sold, a deduction at that time should be permitted.

The treatment of goodwill must also take into account the relationship between the measurement of business income and the tax treatment of corporate source income under the comprehensive tax base. Share gains would be fully taxable and share losses fully deductible, and the tax paid by the corporation would be fully creditable on distribution or allocation to resident shareholders. The market value of shares would generally reflect the goodwill element in the business and, accordingly, once the proposed tax system was in effect, taxation of share gains would mean that gains or losses in goodwill, when realized in market transactions, would be taxed or allowed currently even though such gains or losses would not be reflected in the underlying financial statements of the business. To the extent that the value of the goodwill was thus reflected in the value of the shares, the sale of a corporation's business would not result in any additional tax to the shareholders, for any tax paid on that gain by the corporation would be creditable to the shareholders.

In addition, to permit goodwill to be amortized by the purchaser when there was no demonstrated decline in value would tend to create a tax incentive to business take-overs, because this portion of the purchase price could be recovered through tax write-offs. Furthermore, if all purchased goodwill could be amortized, and all our other proposals were accepted, the possibility of an additional tax advantage would be created because the value of the goodwill at the effective date of implementation would be included in the cost basis of the shares and would be free of tax upon realization by a vendor, but would be amortizable by a purchaser. It might be possible to eliminate this latter advantage by prohibiting the amortization of goodwill that existed at the effective date. However, it would become increasingly difficult to maintain the identity over time of this opening goodwill.

Therefore, we conclude that it would not be reasonable to permit the

amortization of goodwill and other intangible assets of indefinite duration purchased from another taxpayer, and that a deduction should only be permitted upon disposition or when it could be established that a significant loss in value had occurred.

In accordance with our recommendation that all expenditures that meet the three general tests enumerated (that they be related to the earning of income, not be of a personal nature, and be reasonable) should be deductible at some time, expenditures that fall into the classification of "nothings" should be deductible. The only question remaining is the time when such deductions should be permitted. In the same way that it is difficult to identify the extent to which expenditures contributing to goodwill in fact benefit future income, so it is often not possible to distinguish these other outlays as being costs of a current or of a longer term nature. Not only is the accuracy of any allocation doubtful, but uncertainty as to what allocation would be acceptable to the tax authorities complicates the determination of taxable income. For accounting purposes, it is usual to write off against income most of these expenditures when incurred.

We have thererore concluded that the preferable approach would be to permit the immediate deduction for tax purposes of all business expenditures unless the legislation specifically categorized the outlay as one that must be capitalized. This approach is liberal and would minimize uncertainty. These are advantages that should override the arbitrary nature of the designation of certain expenditures as being for the longer run benefit of the business, and therefore subject to amortization over a period of time. To implement this approach, we suggest that a new capital cost allowance class should be established. Initially, the regulations could define this class to include commissions 23/ and other costs of financing; costs of incorporation and other expenses of acquiring or establishing a business; legal and other expenses to defend successfully a franchise or copyright, to obtain long-term contracts, or long-term commercial advantages, for example, lower import duties; and such other similar costs as can be defined. It should not include the costs of investigations or plans that were not in fact proceeded with, because these expenditures do not directly lead to future income, and should be deductible immediately.

In summary, we recommend that the times at which reasonable business expenditures should be allowed are as follows:

1. All business expenditures should be allowed currently except certain designated expenditures that demonstrably benefit the business beyond the taxation year. We have pointed out that many expenditures that produce current revenue also benefit future periods, but are virtually impossible to allocate over appropriate periods. Other expenditures are clearly incurred to produce income for more than one period. We recommend that, on practical grounds, most expenditures should be written off as incurred regardless of the extent to which they provide some future benefit, unless they are specified by the Regulations as falling in one of the classes referred to below.
2. Expenditures that benefit the business beyond the taxation year and are not specifically permitted as a deduction in the year incurred should be segregated into:
   a) Those contributing to inventory value which would later become a cost of sale.
   b) Those attributable to long-term assets, such as equipment and buildings, and intangible assets of limited life, which would be subject to amortization on a prescribed basis.
   c) Others, such as purchased goodwill or other purchased intangible assets of indefinite life, securities, and land, where any loss would be eligible for deduction only on disposition or upon a proven significant loss in value.

   Where a deduction for loss in value of category (c) assets was made without a disposition, and the value of the asset subsequently increased, such recovery would have to be brought back into income to the extent of the amount deducted.
3. Long-term expenditures subject to amortization would include the cost of tangible assets and of certain intangible assets with limited life as currently set out in the Regulations. Any intangible property

not included in another class that had a period of existence reasonably measurable by law, agreement or nature, should be included in class 14.

4. A new class should be added, which would include defined expenditures, whether or not they resulted in the acquisition of property, and should be eligible for an allowance of 20 per cent of the original cost a year.

In view of the above recommendations and others made in this Report, the use of the term "capital" in differentiating expenditures of a current and long-term nature would no longer appear to serve any useful purpose, and we suggest that consideration should be given to discontinuing its use. This would emphasize that the distinction involved is one of timing and not of any inherent quality.

It will be noted that under our recommendations virtually all expenditures would be allowed at some time. The allowance of all business expenditures, even some that might have a long-term benefit, and the introduction of the new class for capital cost allowance would permit immediate deduction or amortization of many outlays that are not deductible under the present tax system. In effect, any business expenditure that did not fall within a capital cost allowance class, was not part of inventory, or was not part of the cost of acquiring an item of property of indefinite life, would be deductible when incurred. Purchased goodwill would not be amortizable, and, accordingly, in the purchase of a business as a whole, the allocation of price between goodwill and other assets would still be important and might cause difficulties. A deduction for purchased goodwill could be made on its eventual disposition or deemed disposition, or upon a proven loss in value, and in this way the existing difficulties should be reduced.

The "Cash" Method of Computing Income. The means we have discussed for placing the measurement of business income of all taxpayers on a common basis would involve recognizing income when it was realized. that is, when property was disposed of or services rendered, and allowing the deduction of costs either as incurred or as the benefits therefrom were used up. This approach

is substantially what is referred to in accounting terminology as the "accrual" method of computing income. Although the accrual method is generally required for computing business income on the grounds that it is the only method that gives a reasonably accurate measure of "profit", section 85F of the Act specifically permits a taxpayer engaged in farming or a profession to elect to use the "cash" method of computing business income.

Under the cash method, income is computed simply by deducting cash disbursements from cash receipts. Thus, sales are not taken into income until paid for in cash, and expenditures are not deducted until a cash payment has been made. Such a system ignores the fact that a sale may have resulted in a legal obligation readily convertible into cash, and that cash laid out may have been replaced by an asset of equal value. It also ignores expenses that have been incurred but not yet paid. Therefore, it is not a measurement of business income but tends to reflect cash flow. In some small businesses cash flow and income will be approximately the same, but this would not apply generally.

The cash method of computing income represents a significant departure from our concept of the best measurement of business income, and results in at least a temporary understatement of income for certain taxpayers. We therefore recommend that the right to use the cash method of computing business income should be restricted. In our view, it would create some hardship to require all farmers and professional individuals to adopt the accrual method because of the accounting and liquidity problems which this might involve for those with relatively small incomes. Accordingly, we recommend that any individual whose principal source of income is farming or a profession should be entitled to continue to use the cash method as long as his annual gross revenue from farming or the profession was less than a specified sum, say, $10,000. We also recommend that all other business income should be required to be computed on the accrual method. If an individual whose principal source of income was farming or a profession adopted the accrual method, either through choice or because his gross revenue exceeded the sum specified, he should not thereafter be entitled to revert to the cash method.

We are aware that the immediate implementation of this recommendation without some transitional provisions could cause hardship for those farming and professional businesses where the cash flow was inadequate to meet the unanticipated tax liability. In addition, there would be a problem where the accounting records were inadequate to compute income on the accrual basis. Therefore, our recommendations should be implemented in stages, starting first with those larger businesses where the cash flow was more substantial and where the records were adequate. The Department of National Revenue could provide standard forms to assist those businesses which required them to put their records in order. We do not feel that the burden of maintaining adequate records or of paying taxes on an accrual basis is unreasonable.

A problem lies in the appropriate treatment of the opening assets (accounts receivable and inventories less accounts payable) of businesses that are on a cash basis, which would be affected by transfer to an accrual basis. To bring such opening assets into income at the effective date would require payment of tax which the taxpayers concerned had expected to postpone until death, or sale, or discontinuance of the business. One possibility would be to exempt these opening assets from taxation, and to regard this as a necessary price of placing all taxpayers on an equal footing in the future. On the other hand, to exempt this income completely from tax would not give equal treatment with other taxpayers including those who, though eligible to use the cash basis, did not elect to take advantage of it and were therefore already "paid up".

Because many taxpayers would consider such a tax to be a special levy, and in many cases would be unable to make payment, equity could be served on transition by establishing for each taxpayer who converted to the accrual basis a contingent liability equal to the tax, which would become payable upon the reduction or ultimate liquidation of the opening assets. This might require a record to be maintained until the disposition of the business or until the taxpayer died or left the country which could be a substantial period of time. Another alternative would be to relate this problem to the determination of the cost basis of the business at the

effective date, for purposes of determining the eventual property gain or loss on final disposition. Thus, the estimated market value of the business at the effective date of the new legislation could be reduced by the excess of the assets over liabilities set up to convert the accounts from a cash to an accrual basis. Then, on ultimate disposition, this adjustment would be taken into income. This procedure would be substantially the same as at present, because a taxpayer is now required to bring into income the proceeds on disposition of certain assets, that is, accounts receivable and inventory. We recommend the adoption of the latter alternative because it would impose tax on the balances outstanding at the valuation date on the same basis as currently applies, because the taxpayer would not face an unexpected tax liability, because it would put the current records on an accrual basis, and because it would tax future profits in each year in which they accrued. When a farm or professional practice was acquired in the future the purchaser should be required to set up the appropriate portion of the purchase price as inventory and receivables, irrespective of the level of his gross revenue, a procedure that should not give rise to liquidity problems.

Business Losses

The proper treatment of business losses for tax purposes raises a number of issues.

The first question we shall consider is the extent to which the government should share in the losses as well as in the profits of business. Under the present system some sharing of losses takes place. If an individual with non-business income incurs a business loss, he may offset the one against the other in the year of loss, and to the extent that the tax otherwise payable on his other income is reduced, the government has shared in his business loss. Similarly, an individual or corporation engaged in several different lines of business at the same time may set off a loss in one business against income of the other.

There is no doubt that a full sharing of losses by the government, involving the payment of subsidies to a business to the extent of its business

loss multiplied by the going tax rate, would have some desirable results. The tax system would no longer make a distinction between businesses which can offset their losses against income and those which cannot, so that a disturbing effect on business activity would be eliminated and equity achieved between taxpayers. In particular, it would eliminate the tax disadvantage suffered by the small, risky business, which is already at a considerable disadvantage compared with the diversified, well-established business. In terms of stability, a sharing of business losses would provide funds in times of low economic activity and thereby act as an automatic stabilizer. Losses would no longer have any relevance for tax purposes beyond the year in which they were incurred or for any taxpayer other than the one incurring them, and the legislation would therefore be simplified.

Despite these attractions, we are convinced that a full sharing of losses by the government would be repugnant to most Canadians. We do not accept the argument that because the government shares in all income it should also share in all losses. Subject to this limitation, however, rules should be devised to place all taxpayers on as nearly equal a footing as possible.

The questions to be answered are when, and to what extent, business losses can reasonably be taken into account in determining income. We have no doubt that a business loss of any particular year should be applied to income from other sources in the same year as is now done. If a business loss is not completely offset by other income in the current year, however, to what extent should it be carried back against income of other years or carried forward against income of future years? Under the present tax legislation, an unabsorbed business loss in one year may, within certain limits, be carried back one year and forward five. In this respect Canada is not unlike many other countries, although the practice varies 24/.

The seven-year span covered by the present loss carry-over provisions might be considered satisfactory from the standpoint of measuring business income if the only cause of business losses was the ordinary fluctuations in business activity. However, the five-year carry-forward period is not

sufficient for a new business that requires a long development period, and the one-year carry-back is often not sufficient for a business that is winding up. As we noted earlier in this chapter, the period over which benefits are received from any given expenditure may be long, and a liberal carry-forward of losses is essential to overcome this limitation of the annual period of measurement. There is, however, an anomaly in the present tax system in that, because of the permissive nature of capital cost allowances, a taxpayer may fail to make any claim for capital cost allowances and thereby in effect carry losses forward indefinitely to the extent that they would have resulted if normal depreciation had been claimed.

The tax treatment of losses can also have either a stabilizing or destabilizing effect on the economy. For example, if losses occur to a greater extent during a downswing or a low level of business activity, tax refunds in respect of loss carry-backs could be helpful in encouraging business expenditure. On the other hand, a reduction in tax as a result of the application of losses against subsequent income could occur during an upswing, and thus encourage an increase in business expenditure when restraint would be more appropriate. Except in very major swings of the economy, however, the importance of the treatment of business losses for stabilization purposes may not be great because the bulk of business income is earned in large businesses which do not incur losses frequently, and because the timing of losses does not necessarily bear a direct relationship to the business cycle.

Apart from the proper determination of business income and the economic considerations which have been discussed above, there is an overriding consideration from the standpoint of equity. With the adoption of the comprehensive tax base a taxpayer should not be regarded as having any taxable capacity until such time as all his losses from any source have been recovered.

We have reached the conclusion that the present seven-year period over which losses may be spread is not adequate to place the measurement of the

business income of all taxpayers on the same basis. Therefore, we recommend that the period be extended to permit losses to be carried back two years and carried forward indefinitely 25/. We do not suggest a longer carry-back because it could lead to administrative difficulties. Furthermore, we do not feel it would improve equity, for shareholders could claim the loss on their shares even if the corporation was not able to carry back the full loss, and because our averaging proposals would provide the individual with a longer period of carry-back.

In general, under the present legislation, a business loss can be offset against any other income of the same year. The only limitation, which we discuss below, is in respect of farming carried on as a side-line activity 26/. To the extent that a business loss is unabsorbed in the current year, however, it can be applied only against business income in the previous year or in the succeeding five years. We think that this limitation is inequitable and that it should be permissible to apply most business losses against all other income during the carry-over period.

Losses of a Personal Expenditure Nature. In Chapter 9 it was pointed out that some "business" losses could in fact be items of personal expenditure, as when the taxpayer is not pursuing a business activity with a reasonable expectation of profit, but may be primarily engaged in a hobby or a form of recreational activity. The reasons for not allowing the deduction of personal expenditures have already been discussed. The problem is in distinguishing between the business that is pursued for profit and the one that is more of an avocation or recreational activity. The present legislation partially recognizes this problem in the case of farming carried on as a side-line activity. However, the question of "hobby businesses" is not limited to farming, and is of particular concern having regard to our proposals for the liberal treatment of business and property losses. Although our proposals would specifically preclude the deduction of personal expenditures, experience has indicated that it is difficult to apply such a provision to many of the expenditures of a "hobby" business, that is, expenditures that

are in fact related to a "business", but one which does not appear to be directed to a business purpose. We were unable to develop a definition of either a genuine business or a hobby business that could clarify this problem and that appeared to be capable of application in a manner that would produce certainty. We therefore recommend that an arbitrary restriction should be employed to ensure that taxpayers could readily determine which business losses were to be considered personal expenditures and therefore not deductible. The limitation should apply when a particular business sustained losses over a lengthy period.

It is our recommendation that losses of a business should be deductible from income from all sources in the year of loss, in the two preceding years, and in future years, unless and until losses have been sustained in three years which fall within a five-year period. However, once losses have been incurred in three such years, any further loss incurred following the third such loss year should not be deductible from any income of the taxpayer (either in the year of loss or any other year) from sources other than the loss business. Such subsequent losses could be carried back two years and forward indefinitely and applied against income of the same business. If, after sustaining such losses, the business then became profitable, and the profits realized in the years subsequent to the loss years exceeded all losses from the same business deducted in previous years (including the losses deducted from other income), such business would again become eligible to claim an unlimited write-off of losses against other income unless and until the three-year rule again became operative. The five-year period is suggested for ease of administration, but if the use of such a period permits some taxpayers to deduct recurring losses of a personal expenditure nature then it should be extended.

It might also be provided that any losses sustained subsequent to the three years would be deductible from all other income if the profits of the business during a period of, say, seven years beginning with the year of loss exceeded the losses during the same period. A provision of this nature would permit, for some businesses, the deduction of a loss from other income in the year of loss, rather than requiring it to be carried forward for deduction from income of the same business.

It is not our intent that our proposals should inequitably worsen the position of the bona fide farmer who needs to take off-farm employment to assist in maintaining and expanding his farm. If it is felt that our proposals would deter such farmers from taking off-farm employment, consideration should be given to a modification of the loss limitation. For example, it might be provided that where stipulated conditions exist income from part-time employment would be treated as farm income.

Because a new business would be permitted an unlimited loss deduction for the first three years, and would only become subject to the above procedure in the fourth year, the limitation should pose no difficulty for new businesses. In this way, the losses of a new business would be eligible for full deduction, without dollar limitation, from other income regardless of whether it was a "hobby" business. This procedure is quite liberal, because 100 per cent capital cost allowances could also be claimed by a qualified new business.

In addition, there are three points relating to the computation of a gain or loss from a business that should ensure that only "hobby" losses were disallowed. First, in Chapter 15 we recommend that certain expenditures relating to non-personal property, such as interest, property taxes, costs of establishing and defending a property right, and damage claims resulting from the holding of property, instead of being written off when incurred, should be permitted to be added to the cost basis of the property if the taxpayer so chose. Second, earlier in this chapter we pointed out that capital cost allowances should not have to be taken unless the taxpayer chose to do so. Both of these options would enable a taxpayer to reduce his losses for tax purposes and should mean that in most cases there would be sufficient taxable income that the three-year loss rule would not apply. The third factor would be a limitation on the taxpayer, for we recommend that in applying the three-year loss rule, gains from the holding or disposition of property of the business (other

than inventory) should be excluded from the computation as being income from property rather than from business.

The recommended provisions should not restrict the claiming of losses by bona fide businesses, but taxpayers engaging in an activity for personal enjoyment would find that the right to deduct any losses from such activity from income from other sources after an initial three-year loss period would be denied under the tests we have suggested. The present hobby farm provision should therefore be removed.

The disallowance of a loss to a corporation would be an idle gesture if the shareholders could then in effect claim the loss when they disposed of their shares at a price less than otherwise could have been realized. However, because the loss would be deemed a personal benefit, the amount would either have to be attributed to the shareholders or deducted from the cost basis of their shares. If this was not feasible, an amount equal to the loss would have to be subjected to the top rate of personal tax on a grossed-up basis. This is the procedure we recommend for other personal benefits which cannot be attributed to specific individuals.

Separate Businesses. Our recommendation for the treatment of losses of a personal nature has implications for the definition of a business. Although the current definition in section 139(1)(e) should be satisfactory for the purpose of determining whether a business exists, it is of little assistance in distinguishing between separate businesses, which would be necessary under our proposals because losses on some businesses would be subject to special limitations. This question has already been raised in Chapter 20, which deals with the taxation of clubs, charities, and certain tax-exempt entities. It would also be important in connection with our recommendations for new and small businesses later in this chapter.

The task of finding a suitable test for a "separate business" is not easy, considering how diverse the business operations of firms and individuals

are, and the degree to which essentially different operations may be integrated with one another.

Under the present Income Tax Act there are provisions which now require the identification and separation of the various businesses that a proprietor, partnership, or corporation might be operating. The most important examples concern the claiming of loss carry-forwards where there has been a change in control under sections 27(1)(e) and 27(5), and the requirement that separate businesses set up separate capital cost allowance schedules under Regulation 1101(1).

Although we do not propose a specific definition of what constitutes a separate business, we suggest that the legislation might contain some provisions on this matter for the guidance of the courts. Generally speaking, where business operations carried on by one taxpayer were interdependent they should be regarded as one business. The operations may be integrated vertically, like flour milling and the bakery business; mining iron ore and steel making; or producing, refining, and marketing petroleum products. Operations might also be integrated horizontally, as in the case of a chain of stores, hotels, or restaurants with central management and service functions. In these cases the operations should all be regarded as one business, even though it would have been possible to operate them separately. On the other hand, if two operations were of different kinds and neither contributed to the other by providing materials or services, promoting sales or sharing services, so that the only substantial connection between them was common ownership, they should be regarded as separate businesses. There would no doubt be many cases when one operation contributed in some way to the other operation. We do not think a token relationship should satisfy the test, but that there should be a genuine and substantial commercial integration.

The present jurisprudence suggests that businesses of an identical

nature may be separate if conducted in different locations. We do not agree that this treatment is fair, and we recommend that operations of a similar nature carried out by the same owner in one or more locations should not be considered as separate businesses.

Somewhat more difficult is the question of whether a business which has been discontinued is the same business once it recommences operations. We recommend that where a business had completely terminated and was recommenced, it should then be considered a separate business. However, this should not be the case if the cessation of operations was temporary and the facilities and basic organization were maintained during the period of cessation.

Consolidated Returns. It is convenient at this point to deal with the situation where a group of corporations is operated under common control. Because the present legislation does not permit the filing of consolidated returns, it is advantageous to conduct operations in one corporation rather than in a number of corporations, so that profits and losses can be immediately offset. The deficiency of the present legislation is evidenced by the fact that many groups of companies have been forced to adopt artificial means of offsetting losses against profits within the group 27/.

Consolidation is permitted in the United States without payment of any extra rate of tax. An 80 per cent degree of ownership is required, and there are a number of special rules, particularly in respect of corporations entering and leaving the consolidated group. In the United Kingdom, consolidation as such is not permitted, but companies with 75 per cent common ownership can in effect offset profits against losses within the group because a profitable company can deduct a payment (referred to as a "subvention payment") made to an associated company which would otherwise sustain a loss.

The failure of the present Canadian tax system to permit offsetting of profits and losses within a group of companies operated under common control does not arrive at a proper measure of the shareholders' ability to pay, and is not in accordance with our recommendations for a comprehensive tax base. It has led to artificial transactions in many cases. We therefore recommend

that the legislation should be amended to permit companies having common ownership to aggregate their incomes and losses for tax purposes. Of course, to the extent that a loss was set off against the income of another related company in the same year, it would not be available for carry-back or -forward. However, if there was an overall consolidated loss in any year, it should be available for carry-back or -forward against the consolidated income for other years of the same group of companies, or of a group which was eligible in the year of deduction to file consolidated returns and included the companies which sustained the loss. For practical reasons the privilege of filing consolidated returns should be limited to situations where there were no minority interests.

Transferability of Losses. We must now consider the treatment of business losses where the ownership of a loss business changes. Under the present tax system, the new owner of an unincorporated business does not obtain any deduction in respect of unabsorbed losses of the previous owner. The same position arises where assets of an incorporated company with unabsorbed losses are purchased. In each of these cases the purchaser is a different taxpayer from the vendor and is not permitted to utilize the losses of the vendor for tax purposes.

Where, however, shares rather than assets of a corporation with unabsorbed losses are purchased and the taxpayer that has sustained the losses, that is, the corporation, continues in existence, the question then arises whether the carry-forward of such losses should be restricted. The present rules 28/ are that losses sustained in an earlier year cannot be carried forward if (a) since the end of that year (or since the winding-up or discontinuance of the loss business in that year) control of the corporation has changed, and (b) during the current taxation year the corporation was not carrying on the business in which the loss was sustained. There is thus a somewhat limited restriction on the carry-forward of losses where control changes. As long as the original business is continued, which is not always easy to determine, the losses may be carried forward notwithstanding that the new owners may inject into the corporation new businesses which are productive of income against which the earlier losses may be offset.

We have stated our belief that a corporation should be regarded as an intermediary for the shareholders. The proposed liberal allowance of losses is not intended to be used in such a way that one taxpayer can deduct losses sustained by another and thereby defer or avoid tax liability. Accordingly, we recommend that losses should not be transferable from one taxpayer to another, and that the right to carry losses forward should be denied to a corporation where there is a change in control, either through a sale of its shares, through granting a right to acquire a controlling interest (unless the right is exercisable only on death or default of an obligation or under a first refusal arrangement) or through a statutory amalgamation. A vendor of the shares who was resident in Canada would, of course, be able to deduct from other income any loss on the disposition of his shares. However, if the change in ownership of the business or control of the corporation took place in a reorganization which was not regarded as resulting in a realization of a gain or loss by the shareholders or by any corporation, 29/ the carry-forward of the business loss should be permitted.

Reference should also be made to an anomaly in the present system, related to the transferability of losses, which arises from the permissive nature of capital cost allowances. A loss for tax purposes may be decreased or eliminated by reducing the claim for capital cost allowances, and some taxpayers are therefore able to transfer business losses freely in the form of unclaimed capital cost allowance on depreciable assets. This would be corrected to a great extent by requiring that all taxpayers claim at least 50 per cent of the statutory capital cost allowances. As already stated, we do not recommend this. Our recommendations would provide more liberal treatment of losses and would thereby reduce the need for a taxpayer to transfer unclaimed costs to another taxpayer.

Under our proposed tax system a shareholder of a corporation which incurred losses would have a much greater possibility of claiming them against his income from other sources. A loss on shares would be fully

deductible when they were sold or revalued, as set out in Chapter 15. In addition, share losses not absorbed against income from other sources in the current year, could be applied against such income in the two previous years or any succeeding year.

The revaluation of securities and the write-off of losses against any income would be particularly valuable in the first few years of a business, and should act as a stimulant to the risk taker. This result is consistent with one of our primary purposes, to assist new businesses.

Transactions Not at Arm's Length

If the business income of all taxpayers is to be measured by common standards, the basis on which transactions take place must be subject to common market forces. Where the two parties to a business transaction do not have opposing economic interests, the actual results of the transaction may not be a reliable basis for taxation because the parties are in a position to arrange the terms of the contract to produce the least amount of tax. Although separate legal entities, they have, by virtue of their particular relationship, a common economic interest, and persons in such circumstances are said not to deal with each other "at arm's length". Legislation has been enacted in many countries to prevent such a relationship between persons from distorting or reducing the tax effects of a transaction between them.

Under the detailed provisions of section 139(5) "related persons" are conclusively deemed not to deal at arm's length, and certain types of transactions between them are subject to provisions designed to adjust the transactions for tax purposes so as to reflect what would have occurred between independent persons. Related persons include individuals related to each other by blood, marriage or adoption, and corporations one of which controls the other or which are subject to common control 30/. It is provided in section 139(5) that it is a question of fact whether two parties not related to each other are dealing at arm's length. So far, however, case law has held that a mutual interest in keeping taxes to a minimum does not, by itself, constitute evidence that the parties are not dealing at arm's length.

In the determination of business income for tax purposes there are at least three factors which can be affected significantly by a relationship not at arm's length:

1. The level at which the price of a transaction is set.
2. The allocation of price between different assets.
3. The time within which the price is payable.

Level of Price. Generally speaking, transactions between parties not dealing at arm's length are subject for tax purposes to a fair market value test, which is applied in different ways to different circumstances. First, specific provision is made in certain cases for the adjustment of the taxpayers' accounts so as to give effect to the fair market value of such a transaction rather than the value attributed to it by the parties. Such provisions are contained in section 17. Second, the Act explicitly provides in section 137(2) for the taxation of "benefits" which are conferred by one party upon another in a transaction not at arm's length, regardless of the form or legal effect of the transaction. Certain other general provisions of the Act can also be invoked to frustrate the artificial effect of transactions not at arm's length as, for example, section 8(1) which is concerned with the conferment of a benefit by a corporation on a shareholder, and section 12(2) which prohibits the deduction of unreasonable outlays or expenses.

Special rules are contained in section 20(4) for determining the capital cost of depreciable property which is acquired by a taxpayer from a person with whom he does not deal at arm's length. The essential purpose and effect of these provisions is to prevent the inflation of the cost basis of depreciable assets upon which capital cost allowance may be claimed by means of artificial transactions between persons who do not act independently.

There is evidence that where corporations were subject to common control, artificial transactions have been used to offset the profits of one company against the losses of another. Common devices included transactions in services and fixed assets which are not subject to the fair market value adjustments provided for in section 17.

In our opinion, the general approach followed in determining the level of prices in transactions not at arm's length has been satisfactory, except for some points we will refer to specifically. Certain of the difficulties which arise under the present law would be removed if our principal recommendations were implemented. For example, the adoption of the comprehensive tax base would eliminate some of the problems relating to the disposition of depreciable assets at artificial prices, because the vendor would bring his entire gain into income and there would be no incentive to inflate the price. Similarly, our recommendation for the consolidation of profits and losses within a group of corporations would remove much of the incentive for artificial transactions within the group. Nevertheless, the need for provisions designed to prevent transactions not at arm's length from being effective for tax purposes would remain, particularly in respect of transactions with non-residents, and we recommend the following changes in the existing provisions:

1. Where a transaction between persons not dealing at arm's length is adjusted for tax purposes to reflect fair market values, such adjustments should be applied to the tax accounts of both parties and for all purposes of the legislation.

2. The fair market value test should be applied to all transactions not at arm's length, including transactions in depreciable assets, payments for services and the use of property, interest, and rent, except in cases where special rules were applicable that permitted transactions to be carried out at prices other than fair market value. These rules are discussed in Chapter 15.

3. As a result of recommendation 2 above, the special rules for depreciable assets which are now in the Act should be repealed.

<u>Allocation of Price</u>. Where different kinds of assets are sold in one business transaction it is possible that, after a total price has been tentatively agreed upon by the usual bargaining between the two parties, the allocation of the agreed value between the various assets may be artificially arranged

to achieve a reduction of tax that can be shared by the two parties. For example, under the present Act, if business assets are being sold and the vendor is faced with a full recapture of depreciation on his depreciable assets in any event, he would not object if some of the value reasonably attributable to goodwill and to land was included in the price allocated to the depreciable assets. Such a re-allocation would create a depreciable outlay to the purchaser and a non-taxable receipt to the vendor; the tax benefit could be shared with the vendor by an increase in the price for the business.

Section 20(6)(g) of the Act provides that where depreciable property and other property are sold together, the vendor's allocation of the proceeds between depreciable property and other assets must be reasonable, regardless of the form of the agreement, and the same allocation must apply to the purchaser. Under section 85E(2), and somewhat in conflict with the preceding provision, the two parties may agree upon the portion of the price that is to be allocated to inventory, and that portion is deemed to be the price for both vendor and purchaser. In the absence of an agreement, the Minister may fix the price 31/. These sections are not specifically concerned with transactions not at arm's length, but do compel both the vendor and purchaser to employ identical valuation procedures, regardless of what may appear to be reasonable for their own purposes.

Under the system of taxation which we propose, the allocation of the proceeds between various assets would no longer be so important, because all the proceeds would be taxable at some time. The time of taxation, however, would still be significant, and legislation along the present lines should probably be retained with modifications. We think it is inequitable and impracticable to require that the allocation of price between depreciable and other property should be the same to both parties. Therefore we recommend that the allocation for each party should be reasonable from his own standpoint, and that the present requirement placing them both on the same basis should be removed.

Time of Payment. At the present time, business income is ordinarily computed on an accrual basis, and other income, such as employment income, on a cash basis. Therefore, it is possible for salary expense to be accrued against a business without the corresponding income being reported by the employee until payment at a later date. Where an employee is in control of the corporation operating the business, he is in a position to use the different accounting methods as a device for delaying the payment of tax. To meet this situation, and possibly to counteract the introduction of fictitious charges by related non-resident persons, section 12(3) was introduced into the legislation many years ago, disallowing until the time of actual payment the deduction of items payable to persons not dealing with the taxpayer at arm's length, and not paid within a stipulated time 32/. In 1964 this provision was repealed and replaced by section 18(1), which is similar in effect to the former section 12(3), but also makes the disallowance permanent at the end of three years unless the parties file an agreement to the effect that the amount in question is deemed to have been received by the creditor and loaned back to the debtor.

Section 18(1) can result in certain anomalies and we suggest that these should be eliminated. For example, it should not apply if the creditor is on the accrual basis and has taken the amount into account in computing its income. Also, if no agreement is filed and the amount is paid subsequent to the three-year period, we think that the deduction should be allowed at the time of payment. Subject to these points, the section seems reasonable and we recommend that it be continued.

NEW AND SMALL BUSINESSES

Dual Corporate Rate

Until 1949 all corporate income was subject to the same rate of income tax. In that year the Minister of Finance introduced a dual rate of corporation

tax with the comment:

> "The House will at once recognize this as tax relief for small businesses and will, I trust, be heartily in accord with the policy. Our country as a whole owes a great deal to the small family type of business. They have to struggle along, grow and develop in competition with large and well financed corporations whose activities may be nation-wide. My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion." 33/

The lower concessionary rate was thus introduced to encourage the growth of small businesses by leaving them with more funds for expansion. Subsequent changes in the concession, by increasing the amount of income taxable at the low rate, have been accompanied by similar statements pointing out the need to assist small businesses. Since 1961, the corporation income tax rates have been 21 per cent on the first $35,000 of income, and 50 per cent on the excess 34/.

Also in 1949 the dividend tax credit was introduced to remove "completely double taxation of small businesses" 35/. This credit now stands at 20 per cent, and, when used together with elections under section 105, has the effect of almost eliminating the "double" taxation for shareholders in low income corporations who have marginal personal income tax rates of 22 per cent or less, and of more than eliminating it for shareholders paying personal income tax at rates of 26 per cent or greater. This rather perverse impact is illustrated in Table 22-1, which shows that in the case of a shareholder in the 50 per cent tax bracket the total tax paid on distributed income would be 38.78 per cent. This latter effect is particularly significant as these tax concessions were only extended to businesses conducted by corporations and were not made applicable to proprietorships or partnerships.

TABLE 22-1

MAXIMUM TOTAL CORPORATION AND PERSONAL TAXES ON CORPORATE INCOME OF $100 TAXED AT 21 PER CENT a/

Marginal Rate of Share-holder %	Corporate Income $	Corporation Tax at 21 per cent $	After-Tax Corporate Income $	Net Personal Tax Rate b/ %	Personal Tax on $79 Dividend $	Total Corporation and Personal Tax %
(1)	(2)	(3)	(4)	(5)	(6)	(7)
10	100	21	79	-10	-7.90 c/	13.10
20	100	21	79	0	0.00	21.00
30	100	21	79	10	7.90	28.90
40	100	21	79	17.5	13.83	34.83
50	100	21	79	22.5	17.78	38.78
60	100	21	79	27.5	21.73	42.73
70	100	21	79	32.5	25.68	46.68
80	100	21	79	37.5	29.62	50.62

a/ Assuming no retention of after-tax corporate income and that the section 105 election is utilized.

b/ Marginal rate of shareholder less 20 per cent dividend tax credit on all of the dividend until the marginal personal rate exceeds 35 per cent, then only on one half the dividend with the flat 15 per cent tax under section 105 on the other half.

c/ Assuming the taxpayer has other income from which this can be deducted.

These figures must be qualified, however, to the extent that earnings are not paid out in the form of dividends. Many shareholders in corporations taxed at 21 per cent have not paid the personal taxes shown in column (6) of Table 22-1. Personal taxes on corporate source income have frequently been reduced or eliminated altogether. The sale of shares of corporations with retained earnings taxed at 21 per cent has made it possible for shareholders to realize all or part of the retained earnings as tax-free share gains. In the case of closely held corporations some relatively small costs have been involved in "surplus-stripping". We estimate that the top combined rate of corporation and personal income tax on low income corporations has been about 35 per cent when the optimum statutory provisions for special rates of tax on distributions have been followed.

This means that high income individuals whose income should be taxed at high marginal rates, have been able to reduce substantially their effective marginal rates of tax by holding the shares of corporations taxed at the low corporate rate. Far from suffering "double" taxation, these individuals have paid less tax on corporate source income than employees, proprietors, and partners have paid on incomes of the same size.

After carefully examining this low corporate rate concession we have come to the conclusion that, in addition to the above inequity, it has the following major defects:

1. The low corporate rate does not apply to unincorporated businesses, which may have just as much or more difficulty in raising funds.

2. An income of $35,000 or less does not mean that the corporation is owned by low income shareholders, that it has few assets or small gross sales, or that it is new. Using the low income criterion as a means of selecting the corporations eligible for the low rate results in a situation where the incentive has little if any relationship to the underlying problem which is the inadequacy of funds for expansion because of the imperfections in the capital market.

3. The low rate is inefficient as an incentive because it applies to the first $35,000 of corporate income regardless of the magnitude of the total income of the corporation. It thus reduces the average rate of tax for larger corporations which have no difficulty in raising capital in the market.

4. The concession is also inefficient because it applies whether the rate of return is high or low, or whether the assets or sales of the corporation are expanding or contracting. The concession has no time limit, so there is no inducement for the corporation to expand. Indeed, as its income expands its taxes increase more than proportionately.

5. By reducing the tax on low income corporations in perpetuity it tends to cushion the market pressures on inefficient and declining firms.

6. The concession also creates many potential avenues for abuse. To stop the worst loopholes it has been necessary to enact elaborate provisions designed to prevent the break-up of "large-income" companies into a number of "small-income" companies that would each enjoy the reduced rate of tax.

For all these reasons we recommend in Chapter 19 that the 21 per cent rate of tax on the first $35,000 of corporate income should be withdrawn, and that a uniform rate applicable to all corporate income should be substituted. We further recommend that this rate should be 50 per cent, including federal income taxes (before deducting the provincial tax abatement) and the old age security tax now levied against corporations. This 50 per cent rate is equal to the top marginal personal rate specified in our proposed rate structure. Because the provincial rates of corporation tax now differ slightly, a uniform 50 per cent rate could be achieved only by federal-provincial agreement. This matter is discussed in Chapter 38.

This does not mean that we believe the Income Tax Act should contain no special provisions for new businesses. On the contrary, we believe that the easy entry of new businesses can play an important role in the Canadian economy, and that preferential tax treatment is one of the ways in which they can be encouraged.

The easy entry of new firms can increase competition and hence bring about a more efficient allocation of resources. Moreover, new firms are frequently the vehicle by which new techniques and new products are introduced into the economy. In fact, an economy that actively encourages new enterprises will probably be one in which established large firms are active innovators as they seek to forestall the growth of competitors.

We are aware that easy entry is not an unmixed blessing in a world where many small investors have very imperfect knowledge. Some industries that are highly competitive with respect to price are characterized by a multitude of small proprietors, many of whom exist only long enough to use up their personal wealth. While this situation may be attractive to consumers, who can thus obtain goods and services below full cost, there is certainly no reason to introduce tax incentives that would encourage this uneconomic behaviour. Nevertheless, we believe that the advantages of fostering easy entry outweigh this disadvantage.

While many new businesses are small businesses at the outset, it is necessary to consider whether encouragement should be given to small businesses generally. It is important to distinguish between help for new businesses that are small because they are new, and help for small businesses per se. In some branches of retailing, for example, many proprietors receive low rates of return on their capital and below market wages for their time. There is chronic excess capacity.

Although directly or indirectly subsidizing small businesses is sometimes justified on political or social grounds, maintaining an environment characterized by countless numbers of small inefficient business units exacts a substantial cost in the long run in terms of a lower standard of living for Canadians.

We do not suggest that the tax system should be used to force a rationalization of industry, nor do we believe we can justify tax measures that have the effect of perpetuating businesses that cannot earn a competitive rate of return, whether they are large or small. Our objective is to

design a tax system that is neutral with respect to the size of the business and to restrict any concessions to new businesses that, because the owners may be relatively unknown or have relatively few assets, are forced to begin in a small way. This is where the capital market imperfections are probably greatest, as we have discussed in Chapter 4.

Investors discount expected rates of return on assets that are risky and for which there is no ready market. Therefore, the expected rate of return required to induce a flow of capital into a new business with untried management must be substantially higher than the expected rate of return required to induce the same flow into large established firms with a record of successful operations. Furthermore, the cost of underwriting small issues of securities adds considerably to the cost of financing new, small enterprises. Private sources of funds are often an expensive form of financing.

Canadian financial institutions have rarely invested in risky ventures. This may be entirely due to the high interest rates available on senior securities, but it could be also partly explained by legislation that restricts their portfolio selection, partly by the fact that they are not eligible for, or are unable to take advantage of, the dividend tax credit, partly by the rules of thumb used to select their portfolios, and partly by the fact that share losses have not been deductible for tax purposes.

There have been a number of important developments in recent years that have helped to reduce the financing problems of new and small businesses. Governments have played an increasingly important and valuable role in assisting them to finance their capital expenditures. The recent development of new financial institutions specializing in intermediate and long-term financing for new and small businesses is also encouraging. Implementation of the recommendations of the Royal Commission on Banking and Finance would go a considerable distance toward removing the remaining barriers faced by new and small businesses in raising funds for development and expansion. We therefore think that the problem of financing the entry of new firms is less pressing today than it was a decade or two ago.

Furthermore, a number of the recommendations we make elsewhere in this Report would help to reduce the barriers to investment in new and small businesses.

1. The liberal treatment of business and property losses would reduce the risk of investing in new ventures. We recommend that taxpayers should be permitted to carry business losses back two years and forward indefinitely, that such losses should be permitted as an offset against other income in any year, and that capital losses should be treated in the same way as business losses. The removal of most limitations on the timing and extent of the deductibility of losses would remove a major disincentive to investment in new and small businesses. The revaluation procedures discussed in Chapter 15 would also assist in this regard.

2. We recommend in Chapter 19 the complete integration of corporation and personal taxes, with a gross-up and credit for resident individual shareholders with respect to the Canadian corporation income tax. A comparison of the present system with the proposed full integration system is given in Table 22-2.

3. We recommend a new personal rate structure with a top marginal rate of 50 per cent.

4. We recommend that the shareholders of an incorporated business should, under certain circumstances, be permitted to file their tax returns as if the business were a partnership. Not only would such an election facilitate the claiming of losses by a shareholder against other income, but it would also enable him to avoid paying the flat rate 50 per cent corporation income tax and instead would allow him to pay his taxes at his own personal rate on a quarterly basis. This would ensure that his cash position was not temporarily worsened by the removal of the low rate of corporation income tax.

These reforms would substantially reduce the hardship that otherwise would be created by the removal of the lower corporate rate, and should to some extent provide an incentive to investment in new and small businesses.

TABLE 22-2

COMPARISON OF CORPORATION AND PERSONAL TAXES ON $100 OF CORPORATE INCOME UNDER THE PRESENT AND PROPOSED SYSTEMS

Present Marginal Rate of Share-holders (per cent)	Present System: Corporation Taxed at 21 per cent With Full Cash Distribution a/	Present System: Corporation Taxed at 50 per cent With Full Cash Distribution a/	Proposed System of Integration of Personal and Corporation Taxes With Top Personal Rate of 50 per cent b/ and With Full Allocation	Difference Between Present System and Proposed System (-) Reduction in Tax (+) Increase in Tax: Corporation Tax of 21 per cent	Difference Between Present System and Proposed System (-) Reduction in Tax (+) Increase in Tax: Corporation Tax of 50 per cent
	(dollars)				
	A	B	C	D(A-C)	E(B-C)
10	13.10	45.00	10.00	-3.10	-35.00
20	21.00	50.00	20.00	-1.00	-30.00
30	28.90	55.00	30.00	+1.10	-25.00
40	34.83	58.75	40.00	+5.17	-18.75
50	38.78	61.25	50.00	+11.22	-11.25
60	42.73	63.75	50.00	+7.27	-13.75
70	46.68	66.25	50.00	+3.32	-16.25
80	50.62	68.75	50.00	- .62	-18.75

a/ For illustrative purposes only. We do not wish to imply that full cash distributions would be usual. The table is for resident shareholders and follows the same assumption as in Table 22-1, where half the distribution was assumed to be under section 105 at a flat 15 per cent.

b/ It is assumed that the present marginal personal rates apply below 50 per cent, and that a 50 per cent rate applies to all taxpayers who previously had marginal rates over 50 per cent.

This is shown by the calculations given in Table 22-2. These calculations assume corporate income of $100 per share and include personal and corporation income taxes with full distribution (or allocation) of all after-tax corporate profits. It will be seen that removal of the low corporate rate, without integration and without the new personal rate structure, would substantially raise the taxes borne by that portion of the corporate stream of income now being taxed at 21 per cent, particularly for the low income shareholder. Under the proposed integration system, however, the increase in tax burden would be moderate and would be confined to the middle and upper income groups. Most shareholders with marginal rates of less than 30 per cent would have a reduction in tax.

However, here, too, this comparison requires careful qualifications. As we have pointed out, there have been a variety of techniques by which middle and upper income shareholders have been able to avoid some or all personal taxes on corporate source income. We have estimated that the top combined rate of tax on low rate corporate source income probably has not exceeded 35 per cent. Therefore, even with integration, the effective marginal rate of tax on high income shareholders in what have been low rate corporations would probably be raised by about 15 per cent.

With abolition of the low corporate rate, full integration of corporation and personal income taxes, and full taxation of share gains, shareholders in corporations that previously enjoyed the low rate would pay exactly the same taxes as individuals earning comparable incomes from employment and from operating unincorporated businesses. This would provide tax relief for the low income shareholder but would generally involve an increase in taxes for other shareholders, because under the present system these individuals are not subject to full progressive rates of tax on all their income (as we define income).

Rapid Write-off of Capital Cost

Despite our great reluctance to recommend the complex tax provisions that are inevitable when the tax structure is used to achieve specific

economic purposes, we believe it would be unwise to recommend withdrawal of the low corporate rate without making some adjustment within the tax system designed specifically to assist new and small businesses. We are concerned that if we did not propose a technique of assistance within the tax system, either our major reforms would be rejected because aid to new and small businesses outside the tax system might be thought to be impractical, or they would be implemented without the adoption of compensating policies outside the tax system, to the detriment of new and small businesses. We have decided that a concession to such businesses within the tax system that would assist in the financing of capital expenditures would reduce the major difficulty that confronts many of these businesses.

The concession we envisage should be designed to accomplish the following objectives:

1. To reduce the cost of capital to new businesses or rapidly expanding small businesses where those who control the business are not in a position either to put up much capital themselves or to raise capital cheaply because of their lack of an established financial position or an established reputation as successful managers.

2. To help fill the gap in the present capital market with respect to longer term financing of capital investment. We think that, in general, the regular sources of financing should provide the required funds for financing accounts receivable and inventory.

3. To avoid creating pressure on taxpayers to change the way they conduct their affairs in order to secure a tax advantage.

4. To promote the expansion of businesses rather than to perpetuate stagnating or declining businesses.

To accomplish these ends, we recommend a system of accelerated capital cost allowances with the following provisions:

1. The concession should be available to all qualified businesses, including farming, without regard to the legal form under which the

business was carried out, that is, corporation, trust, co-operative, proprietorship or partnership.

2. In order to qualify, the business should have to meet three tests for each year in which the accelerated capital cost allowances were claimed:

   a) The assets, after capital cost allowances, of the business and of other businesses controlled by the same shareholders should be less than \$1 million <u>and</u> gross revenues should be less than \$10 million.

   b) At least 70 per cent of the beneficial interest, defined as either the right to control or to receive income, in the business should be held by Canadian residents.

   c) At least 70 per cent of the beneficial interest, either direct or indirect, in the business should be held by one or more resident individuals, no one of whom:

      i) had a beneficial interest of more than 30 per cent in another business that was qualified or had been qualified for the accelerated write-off of capital costs, or

      ii) had, within the previous ten years, owned a beneficial interest of greater than 30 per cent in another business that was qualified for the accelerated capital cost allowance at the time the interest was held.

   In determining whether a 30 per cent beneficial interest was held or had previously been held by an individual in another business, the interests of members of his family unit should be included.

3. The business should be required to apply to the tax authorities for status as a qualified business. The applicant would have to satisfy the authorities that the business met all the statutory conditions in order to qualify. This would be done by an application setting forth the relevant facts of the business. Refusal of the authorities to

qualify a business would be subject to appeal to the courts. If an application or appeal was successful, the qualifications would be effective as of the date on which the original application was made. The procedure would be optional to the taxpayer, and he would not have to qualify an eligible business unless it was advantageous for him to do so.

4. Qualified businesses should be permitted to claim capital cost allowances up to the full actual capital costs in computing taxable income in any one year, or over a period of years, to a total value of $250,000, without regard to the maximum capital cost allowance rates specified in the Regulations.

5. Capital costs incurred before qualification would not be deductible after qualification, except at normal capital cost allowance rates.

6. Having once been deducted, capital costs should not be claimed again under any circumstances. If the assets were sold for more than their undepreciated capital cost the excess would be brought into income in the usual fashion.

7. Businesses in existence at the effective date of the legislation should be permitted to apply for qualification for capital costs incurred subsequent to the effective date of qualification.

8. The definition of a separate business has been discussed earlier in this chapter.

9. If a business had qualified for the rapid write-off in one year, and was subsequently disqualified because of the growth of its assets or sales, the unused part of the $250,000 should be deductible in later years if, through a decline in assets or sales, it subsequently qualified. Ten years after qualifying, the business should be automatically disqualified even if part of the $250,000 accelerated capital cost allowance had not been deducted.

10. A business that exhausted its $250,000 of accelerated capital cost allowances, or became disqualified by the passage of the ten-year period, would not again become qualified.

We are under no illusions that this rapid write-off of capital costs for new and small businesses would be simple to administer. Despite these administrative difficulties, we believe that our proposals would not create the complexities that now exist in the present "associated corporations" provisions of the Act.

When the split corporate rate was introduced in 1949, it was made applicable to all corporations, with the exception that those subject to common control were required to share the low rate of tax. Presumably, it was considered that, even though the existence of separate corporate entities had a sound business reason, they should be regarded as a unit for purposes of the tax relief to small businesses. At the same time, the associated corporations rule was an anti-avoidance measure intended to restrain the the proliferation of corporations purely for the purpose of obtaining additional low rates of tax.

The concept of control in determining association was immediately viewed by taxpayers as too stringent, 36/ and, in 1950, retroactive to 1949, the test of control was replaced by that of a 70 per cent degree of ownership. This basic test was supported by other rules, one of the main objectives of which was to treat individuals not dealing at arm's length as a common group. These rules became more complex and difficult to interpret, and, at the same time, the ingenuity of taxpayers was such that the intent of the legislation was being thwarted. In 1960, the legislation was substantially amended to abandon the 70 per cent ownership test and revert to the test of control. This still proved insufficient to prevent undue advantage being taken of the low rate, and in 1963 the government added the present overriding section 138A(2) under which the Minister may deem corporations to be associated if their separate existence is not solely for the purpose of carrying out their business in the most effective manner,

and if one of the main reasons for such separate existence is to reduce the amounts of taxes otherwise payable. Such ministerial action can be appealed, but will be set aside only if it is determined that none of the main reasons for the separate existence is to reduce the taxes otherwise payable. This last change has probably checked the undue proliferation of corporate entities for tax minimization, but it is based on determining the intention of the taxpayer, which is always difficult, and the appeal provisions seem to be slanted in favour of the Minister.

Our proposal should, if implemented, lead to fewer avoidance problems than the split corporate rate for three reasons:

1. The relief would be available only to qualified businesses and, in order to qualify, the business would have to make an application to the tax authorities. In this way the authorities could obtain all the information necessary to trigger quick action to close loopholes.

2. The rapid write-off of capital costs would be, in effect, an interest-free loan to those small businesses that were acquiring fixed assets within a relatively short period. Because the relief would take the form of a deferment of tax, rather than a permanent remission of tax, this should reduce the lengths to which taxpayers would go to obtain qualification.

3. By restricting the provisions to businesses controlled by Canadian residents, the proposed concession should be more easily policed than the present low rate provision.

It is quite true that we have not defined a new business but only a small business, and so it might be argued that our proposal is no great improvement over the present system. However, it should be noted that after a transitional period of about ten years, during which time all the qualified small businesses would have used up their accelerated depreciation or their qualifications would have expired, the concession would apply only to new businesses. We assume that all small businesses that could qualify would do so as quickly as possible after the provision was introduced.

We emphasize the liberality of the transitional provisions we recommend. Because most existing small businesses would be able to qualify if our proposal was introduced, those that undertook substantial capital expenditures after qualification could probably avoid payment of corporation taxes for several years. If the total income of the business before depreciation did not exceed $250,000 over a ten-year period, and if it acquired depreciable assets to a value at least equal to its income before depreciation, no income tax would be payable for the ten years. Moreover, at the expiration of the qualification period, or on the exhaustion of the $250,000 allowance, the tax burden would not be unduly harsh. Because the tax on business income would then be levied at personal rates, low income individuals who owned or controlled small businesses would ordinarily pay lower taxes than at present, even with the split rate. Upper income individuals in receipt of income from small businesses would pay higher taxes on this income than at present, but this would only bring them into line with other individuals with the same level of income from other sources. The reduction in the top marginal personal rate would ensure that no individual was faced with a marginal rate of over 50 per cent on his business income.

CONCLUSIONS AND RECOMMENDATIONS

COMPUTATION OF BUSINESS INCOME

1. Business income for tax purposes should continue to be based on "profit" as a starting point.

2. Some of the present statutory provisions for computing income should be repealed, as indicated below, to permit the tax authorities and the courts to look more to accounting and business practice in determining profit.

3. The legislation should be amended to ensure that all types of revenues were included in business income, including property gains, gifts, windfalls, and the forgiveness or cancellation of debt.

4. The present provisions for a general disallowance of "reserves", and for the specific allowance of "reserves" in respect of unearned income and doubtful accounts should be repealed. The general statutory test of reasonableness should apply to allowances for unearned income, to estimated losses in value of accounts receivable, and to allowances in respect of losses that could result from guarantees, warranties, and indemnities.

DEDUCTIBILITY OF EXPENSES

5. All expenditures reasonably related to the gaining or producing of income should be deductible at some time. They should be deductible when incurred unless they were applicable to inventory, to an item defined in a capital cost allowance schedule, or to property of an indefinite life such as purchased goodwill, land, and securities. Costs allocated to the first group should be deductible from the proceeds of sales, those of the second group should be amortized as permitted by the schedules, and for the last group, losses should be deductible on disposition or when there was a proven significant loss in value.

6. Any element of personal benefit in business expenditures may generally be allowed in arriving at business income, but should be reported as income of the recipient. If such allocation to the recipient is not possible, the business should be subject to a special tax on such personal benefits on their grossed-up amount at the top personal rate, and this special tax should be allowed as a deduction.

7. The general test of reasonableness should continue to apply to all business expenditures. Where individuals carry on business directly, personal or living expenses of the indiviuals should not be deductible. However, the disallowance of expenditures for the purpose of producing exempt income should be deleted.

8. The present rules regarding inventory valuation should be deleted, and more reliance should be placed on accounting and business practice, with satisfactory guidelines developed by the business and professional community and the tax authorities. The use of the last-in-first-out method of inventory valuation should be allowed on a restricted basis.

9. The amortization of costs provided under the present capital cost allowance system should be continued with the present general level of rates unchanged, but the system should be broadened to cover certain defined outlays now known as "nothings" that are at present non-deductible. The following modifications should be made to the system:

   a) There should be no allowance until an asset has been put into use.

   b) In accordance with our recommendation for a comprehensive tax base, the proceeds from disposal of a depreciable asset in excess of its original cost should be taxable.

   c) A deduction should be permitted to the extent that the unclaimed cost in any class exceeded the original cost of the remaining assets.

   d) Rentals for long-term assets with a purchase option should be allowed only to the extent that they were reasonable and any excess should be treated as being on account of the purchase price of the asset. In addition, there should be a specific provision requiring an amount to be brought into income and capitalized where a lessee acquires, at less than fair market value, an asset which he has been renting.

10. The cost of purchased goodwill, or other intangible assets of indefinite life, would be deductible upon disposition or upon an established, significant loss in value in the same manner as recommended for land and securities in Chapter 15.

ACCRUAL BASIS

11. All businesses should compute income on the accrual basis, including farming and professions, except that an individual whose principal source of income was farming or a profession, and whose annual gross revenue from that source was less than a specified sum, say, $10,000, would be entitled to continue on the cash basis. A transitional provision would defer payment of any tax liability on the initial accounts receivable and inventory until final disposition of the business.

BUSINESS LOSSES

12. Business losses should be subject to the following treatment:

a) The present provisions for applying losses against other income should be broadened by allowing most losses to be carried back against any income of the two previous years, and carried forward indefinitely against any income of future years.

b) Some form of consolidation for tax purposes should be permitted for groups of corporations under the same ownership.

c) Transfer of losses between taxpayers should be prohibited, except on certain tax-free reorganizations.

d) Certain losses, determined by an arbitrary formula, should be deemed to be of a personal nature and should only be deductible from gains from the same business in the two previous years or in any succeeding year.

TRANSACTIONS NOT AT ARM'S LENGTH

13. The rules applied to transactions between parties who do not deal at arm's length should be amended as follows:

a) The test of fair market value should be applied to all transactions between parties not dealing with each other at arm's

length, except where special rules are applicable.

b) Where the purchase price of property has to be allocated among more than one type of property, such as inventory, depreciable assets, and goodwill, each party should be permitted to make a reasonable allocation from his own point of view.

NEW AND SMALL BUSINESSES

14. The dual rate of corporation tax should be replaced by a single rate of 50 per cent which would include the old age security tax.

15. New and small businesses should be allowed to write off expenditures for assets eligible for capital cost allowances at any time, if they so elect, subject to the following restrictions:

a) The privilege would be available only to those businesses, whether incorporated or not, that had gross revenues of under $10 million in the tax year and total assets, net of capital cost allowances, of less than $1 million book value.

b) The privilege would be available only to those businesses that made application to the tax authorities, and would apply only to the cost of assets acquired after the application.

c) The privilege would be available only to those businesses in which at least 70 per cent of the beneficial interest in voting power or profits was owned directly or indirectly by Canadian resident individuals who, together with members of their family units:

i) did not hold a beneficial interest of more than 30 per cent in another business that was qualified, and

ii) had not held, within the previous ten years, a beneficial interest of more than 30 per cent in a business that was qualified at the time the interest was held.

d) The value of depreciable assets the cost of which would be eligible for the accelerated write-off would be limited to $250,000.

e) A business that had ceased to qualify, either because it had used up its $250,000 allowance or because it had failed to use up the allowance within a ten-year period, could not again become qualified.

f) As soon as the business ceased to meet either of the restrictions on gross revenue or asset value, any additional capital assets would be subject to the regular capital cost allowance regulations.

g) All assets of such a qualifying business should be subject to the regular provisions applying on disposition of depreciable assets.

REFERENCES

1/ As used in this Report, the expression "accounting practices" may be taken to include not only the practices of accounting but also the underlying principles on which the practices are based.

2/ Section 85F.

3/ Section 12(1)(b).

4/ Section 11.

5/ Section 3.

6/ Section 27(1)(e).

7/ Sections 27(5) and 27(5a).

8/ As shown, for example, in the case of Atlantic Engine Rebuilders Ltd. v. M.N.R., 64 DTC 5178, where the Exchequer Court expressed doubt as to whether section 85B applied to certain deposits.

9/ See the brief submitted to this Commission by the Canadian Institute of Chartered Accountants, pp. 12-13.

10/ Canadian Institute of Chartered Accountants, Committee on Accounting and Auditing Research, Bulletin No. 9, January 1953.

11/ While it is fairly obvious that material and labour directly used in the production of a product should be included in its value, the inclusion of variable overhead, such as a foreman's salary, is less obvious, and the inclusion of fixed overhead, such as depreciation and property taxes on a factory building, is still more questionable. The general practice varies from including an estimated amount for all the overhead to that of including no overhead, depending on the particular circumstances involved and the theory adopted. (The first approach is commonly referred to as "absorption costing" and the second as "direct costing".) The reason for a variation in practice

is that a business is viewed as a going concern, and consistency in the treatment of inventory is considered more important than accurate reflection of the historical position of the business at a given date. The English courts have held that a taxpayer who has consistently employed direct costing cannot be required to depart from it (Duple Motor Bodies Ltd. v. Ostime (1961), 39 T.C. 537).

In estimating the extent to which the cost of the inventory will benefit future periods, market value is often available as an objective measure. The market value, depending on the type of inventory, may be determined in terms of replacement cost or net realizable value upon sale. If the market value is higher than the cost of the inventory, the full amount of the cost can be deferred, whereas if the market value is lower the usual practice would be to carry costs forward only to the extent of that market value. However, there is some lack of agreement on whether market value should be based on replacement cost or net realizable value, and in determining net realizable value there is dispute as to whether cost should be written down to permit realization of a reasonable profit in the subsequent period.

12/ M.N.R. v. Anaconda American Brass Limited, [1956] A.C. 85.

13/ M.N.R. v. Anaconda American Brass Limited, [1954] S.C.R. 737.

14/ [1952] Ex. C.R. 297.

15/ Striking evidence of this was the change in business practice after the present system of capital cost allowances was introduced in 1949. It was initially provided, until the 1954 taxation year, that a taxpayer could not claim the capital cost allowances unless he entered an equivalent amount of depreciation in his accounts. To obtain the benefit of the more generous tax allowances, many taxpayers changed the amount of depreciation charged in the accounts.

16/ We did receive representations that some of the rates were not adequate, for example, in respect of heavy construction equipment, building equipment, certain hotel equipment, and electronic equipment. We note, however, that the Regulations were recently amended to provide a higher rate for heavy construction equipment. Occasional adjustments of rates are appropriate, although it must be kept in mind that the simplicity of the system arises from the grouping of a multitude of types of assets into a relatively few classes, and the rate for a specific type of asset may well not be accurate.

17/ Recommendations are made elsewhere in this chapter to expand the capital cost allowance system to cover certain "nothings".

18/ R. W. Davis et al., Capital Cost Allowances, a study published by the Commission.

19/ One of which was presented to the Commission by International Business Machines Ltd.

20/ The terms of the legislation appeared to be such that in the case of long-term leases very substantial annual capital cost allowances could be claimed by regarding the purchase price for the property as the aggregate of the annual rentals payable plus the option price. In two recent Exchequer Court decisions, however, the purchase price has been treated as being the final option price: Louis J. Harris v. M.N.R., 64 DTC 5332; Consolidated Building Corporation Limited v. M.N.R., 65 DTC 5211. The taxpayer's appeal in the former case was dismissed by the Supreme Court of Canada (66 DTC 5189) on the ground that the arrangement violated the rule against perpetuities, and that in any event, (a) the final option price was the purchase price on which capital cost allowances should be calculated, and (b) the allowance claimed would artificially reduce the taxpayer's income and should be disallowed under section 137(1).

21/ This discussion of leasing has been in terms of depreciable assets. If land is involved the potential tax reduction is even greater, and similar rules should apply. The offsetting amount would be added to the cost basis of the land.

22/ If a business goes through a lengthy period of development, the costs of development may be amortized over an arbitrary period of operations. Or again, where a business incurs extensive advertising or promotional expenses toward the end of a year, some or all of the costs may be deferred and applied against income of the following year. The problem, of course, is in forecasting the future benefits of such expenditure.

23/ Some controlling provisions might be required because of the possibility of inflating share values and overstating these expenditures.

24/ In the United States a loss may be carried back three years and forward five. The United Kingdom permits an indefinite carry-forward and, on cessation of business only, a three-year carry-back. The Netherlands permits a one-year carry-back, but there is no provision for carrying back losses in France, Germany or Sweden. A carry-forward period of five years is common, although Norway permits a carry-forward of ten years; and, in The Netherlands, where the standard period of carry-forward is six years, a new business may carry forward indefinitely losses incurred in the first six years.

25/ We have proposed that this same carry-over should also apply to most other losses, including losses from the disposition of property (including shares). These loss carry-over rules would be in addition to the methods of income averaging which we recommend in Chapter 13. In the case of corporations, however, the carry-back would be limited to the amount of the income for the years in question which had not been distributed or allocated to the shareholders.

26/ Further discussion of the deduction for farm losses is contained in Chapter 25.

27/ This point was emphasized by the Canadian Bar Association in its appearance before this Commission. Under the present legislation transactions at other than market value are possible in respect of such items as fixed assets, service, and interest, as explained in the discussion later in this chapter of transactions not at arm's length. In addition, the tax authorities do not always insist on the application of the fair market value rule in transactions between Canadian companies.

28/ Sections 27(5) and 27(5a).

29/ For example, by a transfer of assets or shares from one wholly owned subsidiary to another wholly owned subsidiary of the same parent corporation. Tax-free reorganizations and transfers are discussed in Chapter 15.

30/ A modification to this rule is suggested in Appendix A to Volume 3, which deals with tax avoidance.

31/ Where this price is not the fair market value, the question arises whether section 17 overrides section 85E when the parties are not at arm's length. It has generally been departmental policy not to apply section 17 where section 85E applies.

32/ We understand that there was also concern that a Canadian corporation might claim deductions for merchandise purchased from a non-resident parent, and then subsequently receive a non-taxable forgiveness of the liability for the purchases. This possibility would no longer exist under our comprehensive tax base because forgiveness of debt would be income to the debtor.

33/ Budget Speech, Ottawa: Queen's Printer, 1949, p. 14.

34/ This rate includes the 3 per cent old age security tax and is calculated before deduction of the provincial tax abatement. The rate is higher in those provinces where the provincial tax levied exceeds the abatement. See Appendix I to this Volume for a discussion of the dual rate of corporation income tax.

35/ _Budget Speech_, _op. cit_., p. 15.

36/ The major complaint is said to have been that the test of control discouraged the formation of new corporations that depended upon capital furnished by existing corporations, or by individuals who already controlled one or more corporations; _Report of Proceedings of the Fourteenth Annual Tax Conference_, Toronto: Canadian Tax Foundation, 1960, pp. 43-44.

CHAPTER 23

MINING AND PETROLEUM

The Income Tax Act has a number of special provisions relating to the mining and petroleum industries. A detailed examination of their effects can be found in studies published by the Commission 1/. Several participants in our public hearings also submitted extensive studies of the tax provisions together with illustrations of their application under different circumstances. The most significant of the tax provisions from the point of view of revenue loss are outlined briefly below:

1. In general, qualifying corporations 2/ can claim immediately the costs of exploration and development as deductions from income from any source 3/. Any portion of these costs not absorbed against current income may be carried forward indefinitely. Depreciation on plant and equipment is not allowed as an exploration or development cost as such assets are subject to regular capital cost allowance.

2. The income of new mines is exempt from tax for a period of three years 4/. Because a taxpayer may defer deduction of any capital cost allowance or development costs until after this period of exemption, income tax is unlikely to be paid for some additional years after this initial three years.

3. Taxpayers who operate oil or gas wells or mines 5/ (with the exception of gold 6/ and coal 7/ mines, which are given special allowances) are permitted to claim a depletion allowance equal to one third of their taxable income from petroleum production or mining operations. (The term "petroleum" when used in this chapter should be taken to include natural gas.) In general, this provision can be said to reduce the effective rate of corporation tax by one third. Non-operators are entitled to a depletion allowance of 25 per cent 8/ of their gross income from the mining or petroleum operation. In addition, shareholders are permitted to deduct 10 per cent, 15 per cent or 20 per cent

of the amount of dividends paid by certain corporations resident in Canada if the income of the corporation which was derived directly or indirectly from the operation of a mine, oil or gas well meets the prescribed tests 9/.

These provisions of the Income Tax Act and the Regulations have been subject to controversy over the years between those who have argued that they reflect only the necessary distinction that should be made to take account of the peculiar characteristics of these extractive industries, and those who argue that the provisions result in an unwarranted tax concession to a particular type of economic activity.

The present tax treatment of business income has several major defects as discussed in Chapters 9 and 22. In particular, because of the exclusion of capital items from income, some costs are not deductible at any time. The limitations on the carry-forward, carry-back, deductibility against other income and transferability of losses mean that the present system is seriously biased against risk taking by new and small businesses. The low rate of corporation tax on the first $35,000 of corporate income appears to be a relatively inefficient and ineffective method of compensating for the apparent bias of the capital market against risk taking by small firms.

With the adoption of the recommendations made elsewhere in this Report these defects would be virtually eliminated for all businesses. To the extent that the mining and petroleum industries have been particularly penalized by these deficiencies in the present system, these industries would obtain a greater benefit than other industries from the general reforms which we propose.

The defects in the present system are of omission as well as commission. If all costs are made fully deductible, all gains should be made fully taxable. The recommendations made elsewhere would bring into tax all property and other gains at full rates and would subject all corporate income to a

flat rate of tax of 50 per cent. The question is therefore whether the present special tax concessions to the mining and petroleum industries would have any place in a reformed tax system that eliminated some of the defects in the existing system that perhaps justified granting the concessions in the first instance. The great emphasis that has been placed throughout this Report on the paramount importance of horizontal equity and neutrality of tax treatment among different activities means that deviation from the full taxation of all income is only acceptable if there is an overwhelming reason for doing so.

After carefully analyzing the many arguments advanced in support of special concessions to the mining and petroleum industries, we have concluded that, in general, adoption of the reforms recommended for the taxation of businesses and corporations would make the special tax concessions to these industries unnecessary and unacceptable. Percentage depletion and the three-year exemption for new mines are extremely costly in terms of revenue, and the available evidence suggests that these concessions are inefficient (i.e., that they have a relatively small effect on mineral and petroleum exploration and production per dollar of tax revenue forgone).

It is estimated that in 1964 the three-year exemption for new mines and the depletion allowances reduced tax revenues by over $150 million. It is true that in the absence of these concessions the income generated by mining and petroleum almost certainly would have been less, but the increased investment in other industries of funds which were invested in mining and petroleum would have increased taxable revenues from these other industries. Hence, if the concessions are as inefficient as we believe them to be, any overstatement of the revenue loss is relatively small. When it is recognized that $150 million is almost equal to the revenue raised by four percentage points of the corporation income tax, it is apparent that a significant reduction in the taxes levied on other businesses would be possible if the concessions were removed.

There is no doubt that these concessions encourage the mining and petroleum industries. As a result of the concessions, Canada has more investment in these activities, more people are employed in them, and the volume of our exports of minerals and petroleum is no doubt greater and the volume of our imports of minerals and petroleum is no doubt smaller than otherwise would be the case. In addition Canada's known mineral and petroleum reserves are probably somewhat greater than they otherwise would be.

The issue is not the direction of the effects of the concessions but rather:

1. Have the effects been significant?

2. To the extent they have been significant, did the diversion of labour and capital from other uses to the mining and petroleum industries increase or decrease the total output of the goods and services that Canadians want (or that could be traded for such things)?

3. To the extent that the diversion increased the economic welfare of Canadians, could it have been achieved at lower cost?

In our opinion, the concessions probably brought about an increase in the allocation of capital and labour to mineral and petroleum extraction; but there is no presumption that this had a beneficial effect on the overall economic well-being of Canadians. Even if the re-allocation did improve general economic well-being, the concessions were an unnecessarily costly method of achieving this result.

THE DETERMINATION OF INCOME FROM MINERAL AND PETROLEUM EXTRACTION

Discovery Value

The "discovery value" of a mineral or petroleum deposit—the value of a deposit in excess of its cost of discovery—is the net gain in the value of a right to or interest in property resulting from the discovery of a

mineral or petroleum deposit. To maintain equity in the tax system it is necessary that those who realize such net gains, either through the disposition of the interests or rights in the property or through the sale of the minerals or petroleum extracted from the deposits, should be taxed in full on the net gains. It is impractical to tax most property gains on an accrual basis because of valuation problems. This is certainly the case with respect to discovery value. To tax discovery value at the time of the discovery (i.e., on an accrual basis) would be virtually impossible because of the difficulty of estimating the quantity of reserves, the costs of extraction and the trend of future market prices for the product.

Discovery value is, in essence, a capital gain. Because the present tax system does not bring capital gains into tax, it is sometimes argued that to define income from the extraction and sale of minerals or petroleum as the difference between gross revenues and the actual costs of generating those revenues would overstate "true" income because the capital gain element would not be deducted from gross revenues. This overlooks the fact that those who are in the business of making capital gains are subject to tax on those gains, and those who hold rights to or interests in mineral or petroleum properties usually are in the business of making discoveries. In any event, whatever the merits of this argument in the context of the present system, under the system which we have proposed, discovery value would be taxed on the same basis as other kinds of gains and a reduction in income from mineral or petroleum extraction to reflect discovery value would be inconsistent with the treatment accorded other kinds of net gains.

Percentage depletion allowances are also advocated as a method of compensating for the exhaustion of the deposit. In manufacturing, for example, the cost of the machine used up in producing the goods that are sold is deducted from revenues in determining income. It is argued that similarly mineral and petroleum deposits, being wasting assets, are used up by extraction and a similar deduction for the cost of acquiring the asset

is appropriate. This point of view is valid and leads to the conclusion that all of the costs incurred in acquiring mineral and petroleum rights and in discovering and developing the deposits should be deductible from revenue at some time 10/. However, it does not justify the writing-off of discovery values. The discovery value of a deposit is, by definition, the gain in value of a right to or interest in property after deducting all costs of discovery. Discovery value should not be deducted from the revenues from the sale of minerals or petroleum any more than revenues from the sale of manufactured goods out of inventory should be reduced if these revenues exceed the cost of producing the goods sold.

As in the case of other businesses, the income from mineral and petroleum extraction should be determined by including in income all revenues and by deducting from income all of the costs actually incurred in earning that income. There is little if any problem in determining what should be included and deducted in computing income. There is a problem in determining the time at which costs should be deducted in order to measure income from mineral and petroleum extraction in a manner that is comparable with measures of income from other kinds of business.

Exploration Costs Generally

The more uncertain the value of the asset created by a particular expenditure, the more rapidly the cost should be written off. Because the probability of success for a particular exploration venture is usually low, it is reasonable to deduct exploration costs immediately in determining income. The immediate write-off of these costs would be an effective form of tax incentive to new mineral and petroleum discovery and would also be consistent with the recommended treatment of research and product development costs for businesses generally.

Development Costs Generally

Development costs in mineral and petroleum extraction are comparable to inventory costs in, say, a manufacturing business, although the value of the asset created by the latter expenditures is more certain than is the case with exploration costs. Development costs are much more directly related to the earning of future income. In principle, therefore, if the method of measuring income from mineral and petroleum extraction is to correspond with the method of measuring income from other industries, development expenses should be deferred and written off against the revenue received from disposing of the minerals or petroleum in the developed deposit or well.

In order to match development expenses against the revenues from the extraction of minerals and petroleum it would be necessary to segregate exploration and development costs. The dividing line is uncertain in the mining industry and even less clear in the oil industry. But it should not prove impossible to draw up arbitrary but reasonable rules that would separate the two kinds of costs. Ultimately an attempt should be made to do so. The Canadian Petroleum Association has already agreed on some division for statistical purposes. We believe that regulations could be written after discussion between the tax authorities and industry representatives that would provide adequate guidelines for the allocation.

The accounting practices followed in financial statements would not provide a suitable basis for segregating exploration and development costs. Not only is there considerable variation in the practices now followed by companies, but also accounting practices would be adversely influenced if they became significant in the determination of the tax liability.

There are three general ways of determining the write-off of development costs once these costs have been segregated. The first would be to relate amortization to the rate of extraction of the mineral or petroleum. This would match costs against revenue, but it is usually impossible to obtain a reliable

estimate of the total expected production. A second method would be to write off development costs on the basis of the life of the mine or well, subject to an arbitrary maximum period to avoid severe administrative difficulties. The difficulty of obtaining a reliable estimate of the amortization period would remain. The third alternative would be to have arbitrary rates of write-off regardless of the life of the mine or well.

The third alternative would be the most workable and would not unduly depart from the principle of matching revenues and expenses. Accordingly, it would be preferable to establish some general arbitrary rate at which development costs could be written off—as is done for capital assets generally. Depending on the dividing line eventually established between exploration and development costs, the rate of amortization on a diminishing balance basis that would treat the mining and petroleum industries in a manner similar to other industries would be approximately 20 per cent.

Costs other than those related to exploration and development would be deductible from income in the way already recommended for business costs in general.

Exploration and Development Costs in Mining

Development expenses in mining are approximately four times as great as exploration expenses. The Dominion Bureau of Statistics reported that prospecting and exploration costs were about $45 million in 1960. The costs incurred after the decisions are made to develop the mines average about $200 million a year. Our survey of the mining industry 11/ showed that the development period is usually from one to four years in length but may run over seven years. The same survey suggested that of the total expenditures on depreciable assets and development, depreciable assets constituted between 25 per cent and 90 per cent and averaged about 75 per cent. Most of the responding companies in their accounts wrote off their exploration expenses in the year incurred but wrote off development costs against subsequent income from production.

Depreciable Assets Used in Mining

As already indicated, in the mining industry a substantial investment in depreciable assets is required in the development period. Most of these assets are used for purposes of production. While the physical characteristics of the depreciable assets themselves are similar to those used in business generally, the unique feature of mining assets is that they are of little commercial use if the mine is abandoned. It would therefore be appropriate, for the matching of costs against revenue, that the method of writing off the depreciable assets should reflect the life of the mine. Accordingly, to the extent that depreciable assets were used in the development period, depreciation thereof should be treated as part of the development costs and written off in the same manner as other development costs. However, certain depreciable assets, such as a smelter or a refinery, may not be dependent upon one mine for usefulness. In addition, certain associated facilities such as townsites, railways and airports may be constructed primarily for purposes of the mine, but may have other possible uses to the taxpayer in the future. In neither of these cases would a write-off of cost over the life of one mine (or at the arbitrary rates used for administrative reasons in the case of development costs) necessarily be the most appropriate procedure.

The Mining Survey indicated that in the mining industry a great variety of depreciation methods are used for corporation accounting purposes. The straight-line method is frequently adopted, with rates varying from 4 per cent to 15 per cent; but both the unit-of-production method and the diminishing balance method are also employed.

Exploration and Development Costs in Petroleum

Although the breakdown between exploration and development costs in the petroleum industry cannot be determined exactly, the statistics provided

by the Canadian Petroleum Association suggest that expenditures in each of these activities are about $100 million to $200 million annually.

While only a small proportion of exploratory drilling has resulted in productive wells, 80 per cent to 90 per cent of development drilling has been successful.

The appropriate treatment of exploration and development costs for petroleum has raised considerable controversy in accounting circles in Canada and the United States in recent years. Some argue that anyone embarking on an oil exploration programme accepts the fact that a certain amount of drilling will be unsuccessful, and that therefore the cost of the unsuccessful drilling should be treated as part of the cost of the oil reserves resulting from successful drilling. This "full costing" approach would have the deduction of all exploration and development costs deferred in some manner and amortized against subsequent production of oil; it has been gaining some support recently and has been adopted by some Canadian companies. Many, however, object to this method on the grounds that the hope of eventual success may never be realized and that it is not realistic to bring together costs of operation and revenues in unrelated geographic areas 12/.

PRESENT TAX TREATMENT

All prospecting, exploration and development costs, including the costs of oil rights and properties purchased from others, but excluding mining rights, 13/ are generally deductible immediately to the extent of the taxpayer's income from all sources (excluding exempt dividends and before deducting the depletion allowance). Any costs not deducted in the year may be carried forward indefinitely against income of future years.

Once a mine has commenced production, the cost of any further development work (referred to as "forward development") is usually regarded as a current operating expense except to the extent that it relates to underground work designed for continuing use, such as a mine shaft, a main haulage way

or an extension thereof. The treatment of the latter type of expense is set out below.

As already indicated, there are also special provisions permitting depletion allowances to be deducted in arriving at income for tax purposes.

Equipment and structures acquired for use in the production of petroleum are generally entitled, under the present legislation, to be written off on the diminishing balance basis at the rate of 30 per cent 14/.

Mining machinery and equipment and buildings acquired for the purpose of gaining or producing income from a mine (except office buildings that are not situated on the mine property and refineries) are subject to capital cost allowance at 30 per cent on the diminishing balance basis 14/. Mine shafts, main haulage ways and other similar underground work designed for continuing use and constructed after the mine came into production are permitted an annual write-off of up to 100 per cent 15/. This permits the taxpayer to treat them as expenses when he chooses. Associated facilities such as roads, railways, airports and wharfs are subject to the ordinary capital cost allowance rates for such assets, which range from 4 per cent to 10 per cent on the diminishing balance basis 16/. Under the present capital cost allowance system the allowance is dependent upon ownership, and accordingly commences upon acquisition rather than use 17/. No recognition is given for tax purposes to the cost of facilities, such as developed sites and buildings, which are donated by the taxpayer to the local authorities 18/.

In addition to the above provisions concerning the treatment of costs, there are other special provisions, one of the most important of which is the exemption from tax for three years of the income of a new mine. This exemption is rendered more significant by the fact that a taxpayer may defer claiming any capital cost allowance on depreciable assets and any pre-production costs until after the three-year period.

ARGUMENTS FOR SPECIAL TAX PROVISIONS

Based on a review of published material, the briefs presented to us, the views expressed at the hearings and interviews conducted by members of our staff, we found that most of the arguments advanced in support of special tax provisions for the resource industries fell into one or another of five general categories. These categories are briefly described below:

1. The "accounting neutrality" argument: in determining taxable income, all costs of generating income should be deductible at some time; and because of the uncertainty of the return from outlays incurred in the extraction of minerals and petroleum these costs should be deducted quickly. Thus, early write-offs are advocated as a means of achieving inter-industry neutrality.

2. The tax system bias against risk-taking argument: mineral and petroleum extraction is particularly risky; tax systems that lack complete loss-offsets discriminate against risk taking; the present tax system does not provide complete loss-offsets; the present tax system therefore discriminates against mineral and petroleum extraction. Special tax concessions to the extractive industries are therefore required to compensate for this feature of the tax system in order to achieve inter-industry tax neutrality.

3. The capital market bias against risk-taking argument: mineral and petroleum extraction is particularly risky; the capital market discriminates against risky ventures; the capital market therefore discriminates against mineral and petroleum extraction. Special tax concessions to the extractive industries are required to compensate for this market bias.

4. The corporation tax discrimination against mineral and petroleum extraction argument: the corporation tax falls on one factor of production—equity capital; the extractive industries are equity

capital intensive and rely relatively little on debt financing; following imposition of a corporation tax the resource industries either have to raise their prices more in the short run or reduce investment more in the long run than other industries in order to restore inter-industry equilibrium in after-tax rates of return. If the adjustment is through reduced investment, the corporation tax reduces investment in the mining and petroleum industries more than in other industries. Tax concessions to mineral and petroleum extraction are required to compensate for this non-neutral feature of the corporation tax.

5. Expanded investment in the extractive industries confers social and economic benefits argument: expanded resource industries provide benefits to the economy that individual investors do not take into account. Consequently, without tax incentives (or subsidies) there would be too little investment in the resource industries from the point of view of society as a whole. In particular, without tax concessions foreign direct investment in Canada would be reduced and Canadian capital destined for the extractive industries would be invested abroad to the detriment of Canadians. This argument can be broken down into a number of more specific contentions which are listed and discussed later in this chapter.

Some of these arguments are complex, and many of them (particularly the last one) involve issues that go beyond the immediate subject matter of this Report. In the balance of this section we attempt to appraise the principal issues and set forth our views on them. More detailed discussion is contained in the study previously cited 19/.

Accounting Neutrality

Because of the low probability of generating any revenue as a result of an outlay for mineral or petroleum exploration, and because of the long and variable time lags between search and discovery and between

discovery and production, it is argued that all costs should be written off and that they should be written off rapidly in order to achieve a measurement of income from mineral or petroleum extraction that is comparable with the measurement of income from other industries. The rapid write-off of costs that may not be matched by revenues is therefore advocated, in this case not as a concession to mineral or petroleum extraction but as a necessity for inter-industry neutrality in the determination of income. While it is difficult to determine just how rapid the write-off should be to achieve neutrality, we believe that the treatment recommended later in this chapter is liberal. This treatment is basically that the cost of exploration and development should initially be allowed in full as claimed by the taxpayer. After a transitional period the rate of write-off of development costs should be reduced.

The Tax System Bias Against Risk Taking

There are, unfortunately, no accurate and reliable measures of the relative degrees of risk attached to investments in different industries 20/. No one can doubt that the probability of loss on a single exploratory venture in the extractive industries is very high indeed 21/. Whether the probability of loss from such an isolated venture is greater than the probability of loss from a single research experiment by a manufacturing firm, say, in the chemical or electronics industry, is a moot point.

The diversification of risks is an important consideration. Many firms engaged in mineral and petroleum extraction are large enough to be able to undertake many exploratory ventures themselves. Both in mining and petroleum, joint ventures or syndicates are often formed, and through them smaller firms can hold small partial interests in many exploratory ventures. The greater the diversification, the more stable and predictable the percentage of successful ventures. The large manufacturing corporation also can undertake many pieces of research and thus reduce its risk. However, the smaller manufacturing concern usually does not have the opportunity to

participate in syndicate arrangements by which it could have a small share in a multitude of research projects as does a small mining or petroleum company in the case of exploration projects.

Because the joint venture arrangements for the pooling of risks in the extractive industries are more fully developed than in most other industries, to focus attention on the undeniably high risk attached to a particular exploratory venture grossly overstates the degree of risk of investments in the mining and petroleum industries relative to other industries. This is not to deny that the new small mining company or the new small petroleum company is subject to great risk if it cannot enter into joint ventures with other companies or that it is subject to substantial risk even if it can enter into such arrangements. We are not convinced, however, that even these firms are subject to greater risks than small firms in some other industries characterized by rapid technological and product change.

Nevertheless, it is clear that, to the extent that a tax system fails to fully recognize losses through tax refunds, it is biased against risk taking—whether by a small or large manufacturing firm, or a small or large mining or oil company. However, as part of our general reform proposals we recommend a much more liberal treatment of business losses than at present. We also recommend a liberal treatment of property losses to match the full taxation of property gains. Together, these provisions would come close to the perfect neutrality which can only be reached by payment of subsidies on losses. If the tax system accorded similar treatment to gains and losses, so that risk taking was not penalized by the tax system, there would be little need for any special concessions to the mining and petroleum industries even if it was felt that they were characterized by greater risk than other industries.

The Capital Market Bias Against Risk Taking

On the assumption that investment in the extractive industries is

subject to greater risk than investment in other industries, it is also argued that, because the market discriminates against risky ventures, concessionary tax provisions are necessary to compensate for the market bias. A market bias would raise the cost of capital to the mining and petroleum industries. It is argued that, in the absence of concessionary tax provisions, the higher cost of capital would result in too little investment in the extractive industries relative to other industries. Tax concessions that overcame this bias would be efficient in the sense that the additional resources devoted to mining and petroleum as a result of the concessions would yield a more valuable output than if the resources were put to alternative uses.

We are sceptical that investment in the extractive industries is more risky than investment in other industries, given prevailing institutional arrangements. But to the extent that the diversification of risk is not achieved, it is conceded that if investors demand a risk premium to compensate for the uncertainty of the expected returns from exploration there may be some under-investment in the extractive industries—and in other industries with the same characteristics 22/. To compensate for any possible market bias against the mining and petroleum industries we will recommend a special provision that would permit the immediate write down of shares when funds were raised for exploration and development, rather than restrict the write-down to whatever losses were accrued or realized.

Corporation Tax Discrimination Against
Mineral and Petroleum Extraction

It can be argued that the corporation tax discriminates against mineral and petroleum extraction. If the production of the mining and petroleum industries was sold in world markets at prices that were unaffected by the Canadian output, the Canadian corporation tax could not be shifted in the short run through higher prices. Imposition of the corporation tax would necessarily be followed by reduced investment in the

future. Moreover, where Canadian output does affect world prices, to the extent that the extractive industries are more capital intensive than other industries (that is, if they have high physical capital/output ratios) and have lower than average debt/equity ratios, a greater investment adjustment would be necessary for the extractive industries than for other industries to restore equilibrium among after-tax rates of return.

There are five points to be made in responding to this argument:

1. While some Canadian-produced minerals are sold at prices unaffected by Canadian output (notably gold) there are many that are not (notably nickel).

2. Even when the world price is unaffected by Canadian production many other countries that produce minerals and petroleum also impose corporation taxes and these taxes may affect quantities produced and world prices.

3. It would be inconceivable to grant tax concessions to all corporations that are unable to shift the corporation tax through short-run price increases.

4. There are other industries in Canada that are more capital intensive than the extractive industries and some that rely as heavily on equity financing.

5. The proposed integration of personal and corporation income taxes removes any tax discrimination against equity investment that might exist.

We therefore reject this argument for tax concessions for the extractive industries.

Social and Economic Benefits

Finally, tax incentives to the resource industries are advocated on the grounds that they achieve one or more of the following results:

1. Provide employment.
2. Maintain Canada's resource base.
3. Maintain Canada's position as a world producer of minerals and petroleum.
4. Increase Canada's exports.
5. Make Canada more self-sufficient.
6. Encourage direct investment in mining and petroleum in Canada by non-residents and discourage direct investment in mining and petroleum in other countries by residents.
7. Encourage industrial development generally by providing important energy sources (e.g., oil and uranium).
8. Foster regional development, particularly in the far North.
9. Encourage domestic ownership in the mining and petroleum industries.

Needless to say, those who advocate the tax concessions believe all of these alleged results to be desirable. They also assume that:

1. Either the benefits can be achieved without cost; or
2. The benefits outweigh the costs; and
3. To the extent that there are costs, the same benefits could not be achieved at a lower cost.

Since all of these alleged benefits from tax concessions to the extractive industries are dealt with at some length in the studies prepared for us and cited above, we shall discuss none of them extensively, although we shall consider most of them briefly.

Providing Employment. To provide employment when there is unemployment is clearly an advantage. It is not necessarily an advantage, however, if increased employment in the extractive industries means less employment elsewhere. There are more effective methods of preventing unemployment than the provision of industry incentives, as discussed in Chapter 3.

<u>Maintaining the Resource Base</u>. No one would dispute the proposition that, if natural resources could be discovered without cost, then the more natural resources that were discovered the better. But the discovering of additional natural resources is far from costless, and the relevant question is whether the additional discoveries warrant the additional cost in terms of the output forgone when labour and capital are devoted to this use rather than alternative uses. Only if the long-run cost of the new reserves was less than the cost of substitute materials (including foreign supplies) would special tax incentives be warranted. Even then, if the objective was to increase reserves, to be efficient the incentive should apply to exploration and not to development and production. This question is considered again later in the chapter.

<u>Encouraging the Production of Exports and Import-Competing Goods</u>. Minerals and petroleum constitute important exports for Canada and Canadian-produced minerals and petroleum displace commodities that otherwise would be imported. It does not follow, however, that these facts justify special tax concessions to encourage the mining and petroleum industries. To take the view that exports and import-competing industries should be given tax incentives implicitly assumes that, if capital and labour were not producing exports or import-replacing goods, they would not be producing anything else. Over the long run (and that is the relevant period) this assumption is invalid.

Canadians should specialize in producing the goods and services in which they have a comparative advantage and not necessarily the goods that have been exported or that have displaced imports in the past. This can be illustrated in a simple way by supposing that, unknown to anyone, there were no undiscovered mineral deposits or petroleum reserves in Canada, and that the government adopted a policy of subsidizing the production of minerals and petroleum for export. As a result of the subsidy more resources would be devoted to exploration and marginal mines and wells would be brought into

production. By increasing the subsidy, more resources would be devoted to searching for reserves and producing minerals from fewer and fewer productive mines and wells. Less and less of other things would be produced. Canadians would become less and less well off. We do not for a moment wish to suggest that the return from exploration is, in fact, zero. We do wish to suggest that the policy of encouraging a particular kind of export is probably not consistent with the overall economic well-being of all Canadians.

Furthermore, the effect on the balance of payments of increasing the volume of minerals and petroleum exported and the domestic production of import-competing minerals and petroleum is most uncertain. It depends on, among other things, the foreign demand for these products and the changes in the volume and composition of Canadian imports which result from the diversion of resources to the production of more minerals and petroleum. If the foreign demand for minerals and petroleum is inelastic (i.e., small increases in the volume of exports bring about large reductions in price) and resources are taken from other export or import-competing industries to produce more minerals and petroleum, it is conceivable that Canada would weaken rather than strengthen her balance-of-payments position.

<u>Encouraging Foreign Investment in Canada</u>. Many nations, in particular the United States, offer substantial tax concessions to the extractive industries. It is urged that Canada must offer equivalent tax concessions to the extractive industries if the rate of foreign investment in these industries is to be maintained.

The question of foreign investment in Canada is, as the discussion in Chapter 5 points out, extremely complex. Little can be done in a brief review except to call attention to some relevant points:

1. A substantial proportion of foreign direct investment in Canada is probably related to considerations other than the after-tax rate of return to parent corporations. The securing of sources of supply,

investment in a politically stable country near the United States market and the maintenance of a share of the market are clearly significant factors in the decision to invest in Canada. It is impossible to determine with any certainty the sensitivity of foreign direct investment to changes in after-tax rates of return. From what our staff has been able to ascertain about many, if not most corporations, the expected after-tax rates of return are either not computed with sufficient precision to reflect many of the tax concessions now offered to the mining and petroleum industries, or these concessions are not a significant factor in the decision whether or not to invest. Hence, changing the tax system might be of greater significance in the assessment of factors other than the rate of return, such as those mentioned.

2. If it is true, as some persons contend, that international "mineral" capital is exclusively devoted to mineral and petroleum extraction and is seldom available for other forms of investment, there is a strong presumption that it is invested where the probability of finding ore or oil is greatest—and is insensitive to after-tax rates of return.

3. A principal benefit—but not the only benefit—that Canada obtains from foreign investment in Canada is the revenue from taxing the income generated by such investment. To determine the rate of tax on the income from foreign investment in Canada which would maximize the net benefit to Canada would require a knowledge of the sensitivity of foreign investors to changes in after-tax rates of return and a knowledge of the indirect benefits from foreign investment. Neither of these crucial facts is known. If, as we suspect, much foreign investment in the Canadian mining and petroleum industries is insensitive to changes in after-tax rates of return, the net benefit to Canada could be increased by raising Canadian taxes on the income.

4. Undoubtedly, the optimum taxes that Canada should impose on the resource industries are not entirely independent of the foreign tax

treatment of these industries. If foreign governments grant larger concessions to the resource industries than Canada does, the weight of tax that Canada can impose without having some adverse influence on foreign direct investment in these industries is less than it would otherwise be. On the other hand, if foreign governments grant foreign tax credits that exceed current Canadian taxes, the latter can be raised without reducing such investment.

5. How high the Canadian tax on the income of Canadian mining and petroleum corporations could be raised without reducing the net benefit from foreign direct investment in these industries is impossible to say with certainty. It can be argued that higher Canadian taxes on such income would reduce investment in these industries. In some circumstances this would undoubtedly be the case. It is also necessary for Canadians to bear in mind that some investments made in Canada by non-residents could not be made by Canadians because they are only profitable when a market for the output is assured. In some circumstances, only a foreign parent company can provide such a guaranteed market, as was the case in the development of most of the Canadian iron ore mines.

6. The only way to maximize the net benefit for Canada would be to treat each foreign-financed Canadian venture separately, taking into account the sensitivity to differences in tax treatment and the net benefit to Canada that would be provided. This venture-by-venture discrimination is both impractical and unacceptable. Consequently, any uniform treatment applied will result in some instances in less than the optimum net benefit for Canada—because some foreign direct investment that would have provided a net benefit will be kept out by Canadian taxes, and because some foreign direct investment in Canada will obtain a greater after-tax return than the minimum it would have been willing to accept.

7. Adoption of our mining and petroleum recommendations would undoubtedly make foreign direct investment in these industries less attractive than

it is now. Some foreign investment that would have provided a net benefit would be lost, while Canada would obtain a greater net benefit from some foreign investment than it does now.

8. We are also satisfied that it would be a grave error to adopt the approach that, whenever a foreign country adopted a tax concession for a particular industry, an equivalent tax concession should be provided in Canada for that industry so that foreign investment in the Canadian industry would remain equally attractive. Often the best Canadian policy to pursue when foreign governments give large concessions to particular industries would be to import the subsidized goods from the foreign country and devote Canadian resources to producing other goods, or to establish foreign subsidiaries of Canadian corporations in the foreign industry with the concessions to take advantage of the higher after-tax returns.

When there is full employment in Canada we may need net foreign investment to maintain the rate of capital formation without reducing domestic consumption. But usually what is required is access to foreign goods and services in general, not access to foreign dollars destined for a particular use in Canada. If Canada can call upon foreign savings for investment in other industries, Canadian labour and capital can be employed in the resource industries (or any other industry) and foreign goods and services can be substituted for domestically produced goods that are forgone because of the increased investment in the resource industries. Aside from the instances where assured foreign markets or specialized foreign technology are involved, Canada can and should adopt general policies to control the inflow of foreign capital and should eschew industry concessions that could substantially reduce the net benefits from such foreign investments.

Discouraging Foreign Direct Investment by Canadians. If Canada does not match the concessions to the extractive industries given by other countries, Canadian capital destined for these industries may be invested abroad. This

point of view is often expressed by those interested in the Canadian mining industry 23/. It is an argument for maintaining the concessions now given the Canadian mining industry—concessions that are admittedly liberal relative to those offered by most other countries 24/.

With full employment in Canada, increased investment abroad by Canadians, unless offset by increased foreign investment in Canada, would require either a reduction in current domestic consumption or a reduction in domestic investment. If there was no offsetting increase in foreign investment in Canada and the increased investment abroad by Canadians was accompanied by a reduction in current domestic consumption, then Canadian savings would have increased and the national income of Canada would grow more rapidly in the future by the additional income earned abroad by Canadians.

If there was no offsetting increase in foreign investment in Canada and the increased investment abroad by Canadians was at the expense of domestic investment, the national income would grow more or less rapidly depending upon the after-foreign-tax return earned on the additional foreign investment by Canadians, the before-tax return that would have been earned on the forgone domestic investment, and the indirect effects of the two kinds of investments.

Ignoring these indirect costs and benefits, 25/ under the conditions assumed in the preceding paragraph, if Canada gave credit for the foreign taxes paid on the income from such investments, it is possible that a foreign investment that was profitable to the Canadian investor would result in a net economic loss to Canada. The investor presumably is indifferent as to whether he pays taxes to one government or another. However, the net benefit to Canada from the investment would be reduced to the extent that, by investing abroad, revenues were transferred to a foreign treasury. If, as seems probable, the net indirect benefits from investment abroad were less than from domestic investment, the higher the foreign taxes imposed on such

investments and the more generous the foreign tax credits provided by Canada, the more likely that it would be that increased investment abroad would result in a net economic loss to Canada.

The situation would be different, however, if increased investment abroad by Canadians was offset by increased investment in Canada by non-residents. Even if the before-tax rate of return on direct investment abroad was no higher than it was in Canada, Canada could obtain a net benefit from increased Canadian direct investment abroad under some conditions. The conditions would be:

1. Foreign direct investment in Canada was as productive as the Canadian investment it replaced; and

2. Canada taxed the income from foreign direct investment in Canada at a rate higher than other countries taxed the income from Canadian direct investment abroad.

To be more explicit: (a) if the removal of the tax concessions to mining in Canada resulted in increased investment abroad to take advantage of the tax concessions other countries gave to mining; and (b) if non-residents increased their investment in Canada (presumably not in mining) by a corresponding amount; and (c) if Canada was able to tax the income from increased foreign investment in Canada at a higher rate than other countries taxed the increased foreign investment of Canadians, Canada would obtain a net economic benefit from the change.

Enough has been said about the complex issues involved to establish that it is impossible to make any unequivocal statements about the net economic gains and losses from increased direct investment abroad in mining by Canadians.

This leads to the second aspect of the problem. Would a removal of the Canadian tax concessions in fact lead to increased investment by

Canadians in mining in other countries? There can be little doubt that, if the Canadian tax concessions to mineral extraction were removed, foreign direct investment in mining would be relatively more attractive to Canadians than it is now. But the proposals for mining are not made in isolation. The integration proposal, as will be illustrated later in this chapter, would partly compensate resident shareholders for the removal of the concessions, although the after-tax rate of return from Canadian mining corporations would be reduced for many shareholders. However, because we propose in Chapter 26 that the credit for foreign taxes should be restricted to 30 per cent and that the income of foreign subsidiaries of Canadian corporations should be taxed on an accrual basis at a rate of 30 per cent, foreign direct investment by Canadians would also, in some circumstances, be less attractive than it is now.

With offsetting pulls toward other kinds of domestic investment and offsetting pushes away from foreign investment, we are satisfied that a large increase in Canadian investment in foreign mining ventures would be unlikely to occur as a result of removing the special concessions to mining in Canada. To the extent that an increase did occur, it could not be presumed to be against the national interest.

Energy as a Leading Factor for Growth. It may be contended that the growth of the economy is particularly dependent on sources of abundant energy. The implication is that the oil and gas industries merit favoured treatment. The comments made above apply also in relation to this argument. Specifically, if supplies of oil and gas could only be produced domestically at a higher real cost than the cost of importing them, Canada would obtain a net economic benefit if they were imported.

Regional Development. The pioneering role of mineral extraction in the remote areas of Canada is often stressed, particularly in reference to populating the far North. But, as direct employers, mining and petroleum companies do not rank high, and their indirect employment effects in the immediate region of their

mining and producing operations are relatively low. It should also be observed that a forced pace of settlement has certain social costs (i.e., the provision of transportation, housing and associated services) that could exceed the costs to the industry. There is no economic reason why the pace of development of raw materials with higher real costs should be forced before supplies available in more accessible regions have been fully exploited. Nonetheless, many of Canada's remote regions are ill-suited to economic pursuits other than mining and there are non-economic reasons for encouraging the population of some areas.

If settlement subsidies for particular regions are required in the light of national policy, they should not be confined to one type of industry but rather to specified areas. Provision of transportation facilities and social capital are much more effective in partially redressing the problems of high costs and below-standard living conditions than are tax concessions to one type of industry. Nevertheless, if specific encouragement to the extractive industries to develop particular areas is deemed to be desirable, the recently introduced loan fund for exploration in the North is clearly a much more efficient device than general tax concessions to these industries.

A variant of the regional development argument supports aid to sectors of the industry in the interests of slowing or halting the decline of communities. Such is the rationale for the direct subsidies paid to coal mines and gold mines and for the more favourable depletion allowance accorded to these industries. Mining, being regionally specialized, is particularly prone to this "ghost town" problem; but it is not unique. Such subsidization is justified as a short-run measure on the grounds of social cost in terms of human dislocation. In the interest of administrative efficiency, the direct subsidy should be made adequate to the task, and the hidden subsidy, in the form of a more generous depletion allowance, should be abandoned.

But long-run solutions demand a shift of resources from declining industries. In this task government aid should play a role, most obviously in

subsidizing the movement of and retraining of displaced workers, but also, where such movement is not possible or desirable, in the form of incentives to new industry to enter the area. Such a policy of encouraging new industry in declining mining regions need not exclude other branches of mining, which might be given assistance on a regional basis in finding and developing new minerals, without being permanently subsidized.

Encouraging Domestic Ownership in the Extractive Industries. It is argued by Canadian petroleum companies that the present Canadian treatment of the extractive industries is not generous enough because the combined impact of United States and Canadian tax laws favours the operations of United States residents (individual and corporate) over those of Canadian residents. This viewpoint was adopted by the Royal Commission on Canada's Economic Prospects. As a counter measure, that Commission advocated a form of depletion for Canada based on gross earnings.

Given the situation of an independent Canadian petroleum producer, the argument is not without merit. It has, however, also been taken up by the major integrated oil companies, who are currently in the most advantageous position of all, as is shown later in this chapter in Table 23-3.

Such advantages as exist for non-residents apply to Canadian branches of United States companies before their production income in Canada exceeds the cost of their current exploration and development programmes. Prior to reaching this point, these branches can carry forward their pre-production expenses for write-off against future taxable income in Canada. At the same time they can obtain an immediate recovery for intangible drilling costs and the cost of unproductive acreage against income otherwise subject to United States tax, without affecting the size of their concurrent depletion allowances in the United States. A Canadian company, on the other hand, gets no depletion so long as its write-offs exceed its production income. However, once the United States company attains a tax-paying position in Canada it loses this advantage. It has, in addition, to contend

with the 15 per cent non-resident withholding tax. The effective rate of tax on its Canadian operations then becomes the higher of the Canadian and United States rates that apply to that part of its total operations.

The major international integrated oil companies with Canadian affiliates incorporated in Canada, and which account for the major proportion of the impressive statistics on United States ownership of Canadian petroleum resources, do not have any advantage in Canada that stems from United States tax law. Integrated oil companies, whether they be Canadian or non-resident-owned, do have some advantages under Canadian law. The chief advantage is that, if their write-offs of exploration and development costs exceed their production income, the excess may be written off against refining and marketing income.

A liberalization of the Canadian depletion allowance would, of course, apply to the previously mentioned United States subsidiaries as well as to Canadian-owned corporations, thus reducing the claims for Canadian tax paid that the former would make on their United States returns. The net effect, then, could well be a transfer of revenues from the Canadian treasury to the United States treasury.

It is probable that the dominance of United States-controlled companies in the Canadian oil industry is an episode in the world-wide integration of the industry and does not stem from the application of tax laws. Furthermore, the very success of Canadian crude in penetrating the United States market may in part be a result of that dominance.

We are satisfied that a further tax concession to the resource industries in the form of gross depletion would not, if it had any effect, produce more than a minor increase in Canadian ownership. The adoption of our integration proposal should be more effective for this purpose and would not involve a transfer of revenues from the Canadian to foreign treasuries.

As we will show later in this chapter (see Tables 23-4, 23-5 and 23-6), although our proposals would increase the after-tax rate of return to Canadian shareholders, the taxation of share gains would mean that the total after-tax return to a substantial proportion of the Canadian shareholders in Canadian mining and petroleum corporations probably would decline. To the extent that this reduction was not shifted through higher mineral and petroleum prices, it would be capitalized in lower share prices. The total after-tax return on most shares of corporations not in the extractive industries would probably rise as the net benefits of integration not lost through short-run shifting were capitalized. Most resident shareholders, then, would generally realize windfall losses on shares in Canadian mining and oil companies and windfall gains on the shares of other Canadian corporations.

The after-tax return on Canadian mining and petroleum shares would be reduced more for non-residents than for residents because the former would not obtain the benefits of integration. Non-resident portfolio investors would therefore generally find it to their advantage to sell their shares to residents.

The after-tax rate of return to non-resident direct investors in Canadian mining and petroleum would also be reduced. However, because the price that could be obtained for the shares of most large Canadian mining and petroleum companies would likely be less than at present, there would be no incentive to non-resident parent corporations either to sell the outstanding shares of these subsidiaries to Canadians or to offer them new equity issues.

Foreign-controlled companies raising funds for exploration and development might find that new issues commanded higher prices because of the special write-off that we will propose for such issues. This write-off would reduce the cost of Canadian equity capital to these companies, and more new issues for this purpose by foreign-controlled corporations might occur.

A SUMMARY OF OUR VIEWS

After reviewing all of these arguments we have reached the conclusion that:

1. if all costs were deducted at some time in the determination of business income from the extraction of minerals and petroleum,
2. if these costs were written off rapidly to reflect the uncertainty of the return that would be generated by these outlays, and
3. if the tax treatment of losses was such that risk taking was not discriminated against by the tax system,

the only ground for special tax concessions to the extractive industries would be to compensate for the possible discrimination against risk taking in the Canadian capital market. In other words, to the extent that there was a bias in the capital market against risk taking, and to the extent that mineral and petroleum extraction was unusually risky, a deviation from a neutral tax system would be justified to compensate for this bias, assuming that more efficient methods of compensation were not available.

It has already been pointed out that the large corporations in the extractive industries can spread the risks of exploration by undertaking either several ventures at once or a series of ventures and by participating in syndicates which take a partial interest in several ventures in order to pool risks. The large and established companies can also offset the costs of unsuccessful exploration ventures against production income. These companies, in effect, obtain refunds of taxes on their exploration losses.

There is no question of capital market bias against these large companies in the extractive industries. They are able to raise capital in the market at costs that are no higher than those incurred by corporations of comparable size in other industries, as their price/earnings ratios attest. To the extent that it exists, the capital market problem is confined to the financing of mineral and petroleum exploration by small, recently established

corporations that do not have the financial resources needed to spread the risks by carrying out many ventures simultaneously, cannot join syndicates (or enough syndicates) to pool risks, and do not have income from mineral or petroleum extraction or refining against which the costs of unsuccessful exploration ventures can be offset. Under these conditions the cost of capital for mineral and petroleum exploration is probably high. However, it is difficult to say whether the cost of capital is higher for such exploration than for research by small manufacturing companies.

While the capital market may be biased against exploration under some conditions, there is little if any evidence that known mineral and petroleum reserves are inadequate. Present reserves are adequate for current requirements, and for most minerals the reserves are growing rather than declining relative to current output. The question of oil reserves requires specific attention. Although the market bias against risk taking may adversely affect independent oil companies, the seriousness of the problem should be judged in terms of Canada's oil reserves.

We have been told that there are no insurmountable technical obstacles to the commercial production of oil from the Athabasca tar sands. The principal problem is that, if oil from the tar sands is to be competitive with conventional crude oil, large scale productive facilities are required and these must operate near rated capacity. With the output of conventional crude oil substantially below 50 per cent of capacity, the Province of Alberta has been reluctant to grant permission to the industry to proceed with the exploitation of the tar sands on an adequate scale because this would entail a cut-back in the production of conventional crude. But if costs of conventional oil exploration continue to rise it is apparent that, if the tar sands are not now competitive with conventional crude, they will be competitive in the near future, and Canada's oil reserves, for all practical purposes, will be limitless. Devoting resources to the search for conventional oil is, or will become, unnecessary. Hence, to grant

increasingly generous tax concessions to encourage the discovery, at higher and higher costs, of more conventional oil when tar sands crude was available in limitless quantities but could not be exploited because of the limited market, would be perverse.

We have generally adopted the view that wherever possible, when incentives are needed, subsidies rather than tax concessions should be granted. The cost of subsidies is apparent and they can be equally efficient as, or more efficient than, tax concessions. If public policy dictates that mineral exploration should receive greater encouragement than would be provided by the tax treatment that we recommend, any or all of the following measures would be effective:

1. The recently announced government loan programme for exploration in the North could be expanded.

2. Increased subsidies for transportation, communication and geological surveys could be made.

3. A subsidy equal to a fraction of additional exploration expenses could be provided.

We have therefore come to the conclusion that the need for special encouragement to mineral and petroleum exploration to compensate for a capital market bias against risky ventures is small, if it exists at all. We are also convinced that there are fiscal methods available that would be as efficient as, or more efficient than, tax concessions in encouraging exploration if this was deemed to be in the public interest. It is against this background that the efficiency of the present concessions will be analyzed.

EFFICIENCY OF THE PRESENT MAJOR TAX CONCESSIONS

The purpose of tax concessions to the extractive (or any other) industries is to make additional activity more attractive. This can be done by increasing the after-tax net return on investment in an attempt to expand

investment, and thus lead to increased exploration, discovery, development and output. But concessions related to current profit, such as percentage depletion and the three-year exemption, are inefficient devices for increasing the long-run supply of minerals and petroleum because they apply to the output that would have occurred without the incentive as well as to additional output. From this starting point the effect of the present concessions may be reviewed briefly assuming that the tax reduction resulting from the incentive is not shifted in the short run through lower prices or higher costs.

By increasing immediate profits, the tax concessions increase the capitalized market value of existing assets in the industry, including the equity shares of existing corporations and the value of proven or potential reserves. However, if the establishment of new mines or new petroleum wells is barred, either through monopoly control or through the prohibitive cost of new discoveries, such tax concessions are pointless.

If the opportunity to open up new deposits is relatively unrestricted and if long-run costs do not rise sharply, higher current profits resulting from the introduction of tax concessions will induce a shift of resources into the industry. If this happens, and if the country's increased output of the given mineral can be sold with no appreciable reduction in price, windfall gains to owners of existing assets will be at a minimum. The tax concessions will be as efficient as possible. An allocation of resources that is different from what it would have been under free market conditions will have been achieved.

However, if the price is maintained by effective control of total output and if there is freedom to open up new deposits, new investment will indeed be attracted by the tax concessions but it will result in idle capacity. There will be no increase in the output of the industry in question and less of other commodities will be produced. In this sense the re-allocation of society's resources will have been wasteful.

On the other hand, if output is permitted to rise but prices are highly sensitive to the country's output, the additional output resulting from a net increment in investment will quickly reduce profit expectations from further increments. The sensitivity of price to output will depend, in particular, on the size of Canada's output in relation to world demand for a given product. If small increases in output lead to large price reductions, there will be little impact on the country's final output as a result of the concessions.

Depletion Allowance to Operators. Percentage depletion is an extremely expensive incentive for encouraging mineral and petroleum exploration for the following reasons:

1. The incentive is related to current profit and not to costs. The impact of the incentive is therefore indirect—the after-tax rate of return on production is increased and this increases the value of mineral and petroleum resources, and hence encourages exploration. More exploration could be encouraged at the same revenue cost, or the same exploration at a lower revenue cost, by relating the incentive to additional exploration, so that exploration that would have taken place without the incentive would not be unduly rewarded.

2. Because exploration expenses must be deducted before depletion can be claimed, the more a corporation spends on exploration the less it benefits from depletion. This objection could be removed by the adoption of gross depletion; but as already stated, the additional revenue cost would be substantial and the incentive would still be less efficient than a direct subsidy to exploration.

3. The depletion allowance provides a benefit only to established corporations with operating income. Both in mining and oil a few corporations (eight in all) claimed substantially over three quarters of the more than $150 million claimed in depletion by mining and petroleum

companies in 1964. The smaller corporations obtain little if any direct benefit from this concession, which favours most those corporations which need it least, because the cost of capital to the largest mining and petroleum corporations is comparable with that of corporations of similar size in other industries.

Deduction of Exploration
and Development Costs

The rapid write-off of exploration and development expenses yields an imputed interest saving. As a device intended to cause the re-allocation of resources, this concession is the most efficient of those under consideration. It has the great virtue that there is a direct relationship between the stimulus and the desired response.

The present deduction provisions can, however, be subjected to two major criticisms. First, they are more advantageous to those corporations which have operating income and so can immediately utilize the rapid write-off, than to those that do not. Second, the privilege applies to all stages of pre-production activity—from primary reconnaissance through to final development. Given that the risks of failure have been greatly reduced by the development stage, the direct effect of the rapid write-off provisions for development costs is likely to be a more rapid development of known mineral deposits and petroleum reserves rather than a search for new deposits and reserves.

The Three-Year Exemption for New Mines

Where the three-year exemption is an alternative to the write-off provisions, as it is in the case of a short-lived mine operated by a corporation without operating income, this exemption adds little to the profitability of a mine. However, where it is applied in addition to the write-off it may add substantially to the profitability of a mine, especially where the write-off is obtained immediately against other income. Thus, it is relatively advantageous in the case of a short-term project that is associated with an existing mining organization.

As an incentive device the three-year exemption is more efficient than the depletion allowance. Its impact is related only to the early productive period of a mine and not to its lifetime income, so that the primary influence of the three-year exemption is not on asset values in the entire industry but only on those mines that are in the development phase. Since it is more selective, it may be less costly for each unit of additional activity induced than the depletion allowance; but even so it involves large elements of waste. The exemption is applied to all new mines whether or not their development would have taken place in its absence. In terms of benefits, the additional production with which it can be credited is only from those properties which would otherwise have been expected to return less than the minimum acceptable profit.

Here too the incentive provides the greatest benefit to those who need it least. During the period 1955 to 1964, five large mining companies reported about 70 per cent of the income exempted under the new mine provisions. These corporations had operating income against which exploration and development expenses could have been immediately offset, and they operate on such a large scale that they are quite capable of spreading their risks. There is no evidence of a capital market bias against their shares. Three of these companies claimed $117 million in tax-free income in 1964 alone—at a tax revenue loss of nearly $60 million. It is open to question whether this tax saving had a major impact on the investment expenditures made by these companies. Even if it did, it is most unlikely that the benefits obtained exceeded the lost tax revenue.

THE PROPOSED TAX TREATMENT

If we were recommending a tax system that accorded only such concessions to the mining or petroleum industry as are recommended for industry in general, the depletion allowances would obviously be eliminated as would the three-year exemption for new mines. All costs, including property costs, would be deductible at some time and at the following rates:

1. Exploration costs would be written off immediately. Depreciable property which was useful only in connection with one exploration project would be included in this classification. If there was insufficient income to absorb such costs currently, they would be carried over for deduction from income in a subsequent year.

2. Development costs (excluding the cost of acquiring properties or property rights) would be amortized on the diminishing balance basis at a rate of, say, 20 per cent.

3. Equipment, buildings and other facilities used in the development and production phases would be amortized on the diminishing balance basis at the same rate of 20 per cent, as their usefulness would be closely related to the life of a particular mine or well. A smelter or refinery should be permitted only the regular rates of capital cost allowance applicable to buildings and machinery generally.

4. The 100 per cent capital cost allowance for small and new businesses would also apply to mining and petroleum.

5. The cost of purchasing a mining or petroleum property would be amortized on a time or a production basis where the property had an ascertainable useful life or where the amount of reserves was determinable. On the other hand, if both the useful life and the quantity of reserves of the property were indefinite in duration and amount, the cost would be written off only to the extent that a loss in value could be shown to have occurred.

6. The write-off of development costs and depreciable assets used in development and production would not be permitted until production commenced, consistent with the proposed general rule that, in the absence of a concession, capital cost allowance should not be claimed until the assets are put to use.

7. Capital outlays which did not result in the acquisition of property would be deductible either directly or by way of capital cost allowance in the manner recommended in Chapter 22 for "nothings" generally.

The Proposal

It is our view that this method of determining business income should not be immediately applied to income from mining and petroleum operations. While it represents the same tax treatment as would be applicable to other industries, its immediate adoption might well have major adverse effects. However, the present depletion allowance for both mining and petroleum and the three-year exemption for new mines appear to us to be not only more generous than is necessary to compensate for any risk factor but are, in addition, inappropriate and inefficient incentives. In our view, to the extent that there is to be a divergence from a neutral tax treatment, it would be better to permit an accelerated write-off of all costs, including the cost of properties, development costs and the cost of depreciable assets which are useful only for a particular exploration or development project or for production from a particular mine or oil or gas well (but not the cost of smelters and refineries). When combined with the deductibility of share losses and the more liberal treatment of business losses, such treatment should be quite adequate to offset any bias in the capital markets that might exist against the mining and petroleum industries. The operator of a mine or oil well would therefore pay little tax until he had recovered all of his costs. After that point, there is no reason why his income should not be taxed in full.

However, it must be emphasized that a tax treatment incorporating these special write-offs would be considerably more liberal than the treatment recommended for industry generally and need not be extended indefinitely to all mining and petroleum companies. We will therefore propose the gradual restriction of some of these write-offs to rates of capital cost allowance that would be closer to those provided for industry.

We have agreed that there may be some capital market bias against small and medium-sized mining and petroleum companies, although smaller companies in these industries probably do not face financing problems significantly more difficult than those encountered by manufacturing concerns of the same size. On the other hand, we were unable to find any evidence that the larger companies in these industries were subject to any capital market bias. Therefore, to achieve inter-industry neutrality, any special write-offs for the extractive industries should, in the long run, be limited in amount. They should also be restricted to the smaller companies. We considered whether the provision already outlined in Chapter 22 for new and small businesses would be satisfactory in this regard. The allowance of 100 per cent capital cost allowance is quite sufficient as a concession, but there remains the question of what size of operation should qualify for this treatment. The limits suggested in Chapter 22 refer to assets (net of capital cost allowance) of under $1 million and to annual gross revenues of less than $10 million. Of these two limits, the one applying to assets would be more significant for the mining and petroleum industries. Thus, although the new and small business provision would be of assistance to a new mining or petroleum company, it would not assist a medium-sized company that had accumulated assets in excess of the stipulated limit. We therefore examined alternatives that would have some effect on medium-sized companies, as well as on smaller companies which had used up the $250,000 of accelerated capital cost allowance permitted under the new and small business provision. We rejected an expansion of the limits on the size of assets or revenues that would be applicable only to mining and petroleum companies, as this would increase the administrative difficulties to which the new and small business provision would give rise. At some future date such a special provision might be a useful means of extending accelerated capital cost allowances to more mining and petroleum companies.

We believe that another proposal we make later in this chapter for a special write-off for shareholders who acquire newly issued shares of mining

or petroleum companies would be of greater direct benefit to these companies. This latter provision would not be restricted to companies of any particular size, but we would expect that it would primarily be utilized by small and medium-sized companies undertaking an exploration or development programme.

Our specific proposals, which we discuss in more detail in the following pages, are these:

1. The present depletion allowance for the mining and petroleum industries and the three-year exemption for new mines should be withdrawn.

2. Exploration costs (including the cost of depreciable assets that can be used only in connection with a specific exploration project) should be included in a separate capital cost allowance class with a rate of write-off of 100 per cent.

3. Development costs (including the cost of depreciable assets which can be used only for production from a particular mine or oil or gas well) should be included in the same capital cost allowance class with exploration expenses during a transitional period of five to ten years. Thereafter they should be segregated in a separate capital cost allowance class and subject to write-off at a rate of 20 per cent to 30 per cent on a diminishing balance basis.

4. The cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The costs should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. The capital cost allowance rate should be substantial (say, up to 50 per cent) in the transitional period, but thereafter should be set at 10 per cent to 20 per cent of the operating revenue from the property. In addition, if the property is disposed of, abandoned or becomes valueless, the unamortized balance should be written off.

5. Losses in the mining and petroleum industries (whether they result from the write-offs referred to above or otherwise) should be available in the same way as other business losses for carry-back two years and forward indefinitely. They should also be subject to the rules we have proposed to restrict the transferability of losses, but Canadian resident shareholders would be entitled to deduct losses on shares.

6. All profits made on the disposition of mining and petroleum properties should be included in income, in accordance with the comprehensive tax base. The full gain should be included in income, even if some portion of that gain accrued prior to the effective date of the legislation implementing our proposals. However, where shares are disposed of by persons who are not in the business of dealing in securities, only the profit accruing after the date of the legislation would be included in income.

Three-Year Exemption and the Depletion Allowance

Our reasons for recommending the withdrawal of these concessions will be apparent from the discussion earlier in this chapter. We have concluded that they are more liberal than is justified by any disadvantage of the petroleum and mining industries in obtaining capital and, furthermore, are inappropriate and inefficient incentives. Our recommendation for withdrawal extends to all the depletion allowances—for operators, non-operators and shareholders.

As we have said, we recognize that the withdrawal of these depletion allowances and the three-year exemption and the simultaneous imposition of a restriction on write-offs to regular capital cost allowance and amortization procedures could result in a serious impact on the larger integrated companies in the mining and petroleum industries. While most of the benefit of these concessions (particularly of depletion) accrues to the larger and better financed companies, nevertheless the smaller companies plan their affairs

in anticipation of being in a position to benefit from the concessions, and certainly the three-year exemption has benefited some smaller mining companies. Therefore, while we recommend the immediate withdrawal of percentage depletion, we suggest that provision be made for transitional periods for both the withdrawal of some of the more liberal write-off provisions and the withdrawal of the three-year exemption for new mines. We recommend that the exemption continue to apply to new mines brought into production during a five-year period, but that for this period the amount of exempt income for any one mine should be limited to $1 million.

We will also propose a further measure that will reduce the impact of the withdrawal of percentage depletion by permitting the deduction, over a transitional period, of a portion of those property costs that were not deductible in previous years. This deduction is discussed in greater detail later in relation to the treatment of property costs.

Withdrawal of percentage depletion and the three-year exemption would be major changes in the tax structure and would greatly increase the future tax liabilities of the few large integrated mining and petroleum corporations. It would undoubtedly make capital formation by these corporations less attractive than it has been in the past. However, it would be a mistake to over-emphasize the magnitude of the negative effects. The rate of capital formation by some of the largest companies probably would not be greatly affected because they enjoy a substantial degree of market power and only increase capacity to meet increasing demand or to maintain a share of the market.

The after-tax rate of return to many Canadian shareholders on investments made by many of the smaller companies that have relatively little operating income would be materially improved. (See Tables 23-3 and 23-6.) However, the benefit to Canadian shareholders of our proposal for the integration of corporation and personal income taxes would in many cases be offset by the full taxation of share gains.

If percentage depletion is regarded as compensation for the present limitation on the deduction of costs, the justification for such depletion would disappear under the proposed tax system. If percentage depletion and the three-year exemption for new mines are looked upon as compensation for the bias against risk taking in the present system because of the restricted treatment of losses, adoption of the proposed reforms would eliminate the need for such compensation. If the bias in the capital market against risk taking or the indirect economic and social benefits of mineral and petroleum extraction are thought to warrant an incentive for mining and petroleum, then our recommendations embody such an incentive. Because the recommended treatment satisfies all of these requirements, we have no hesitation in recommending the abolition of percentage depletion and the three-year mining exemption.

Exploration Costs

We propose that the costs of exploration, including the cost of depreciable property which can be used only in connection with a specific exploration project, should be included in a new capital cost allowance class which could be written off at the rate of 100 per cent. If the amount claimed in any year exceeded the income of the taxpayer, the deduction would result in a loss which, under our general proposals, would be available for carry-back two years or forward indefinitely against income. If the taxpayer was a member of a group of companies which filed consolidated returns, the loss could be offset against the income of other companies in the group in accordance with our recommendation.

The immediate write-off of exploration costs is a concession that is similar to the proposed write-off of all costs of research and product development for industry generally, and is an incentive that can be supported on general economic grounds.

Development Costs

We recommend that initially development costs, including the cost of depreciable assets which can be used only for production from a particular

mine or a particular oil or gas well, should be treated in the same way as exploration costs and should be included in the same capital cost allowance class—although we have indicated that such development costs should in principle be deductible only over a period of years. We recommend that after a reasonable transitional period of, say, five to ten years, these development costs should be segregated in a separate capital cost allowance class and should be subject to write-off at a rate of, say, 20 per cent to 30 per cent on a diminishing balance basis. When this separation between exploration and development costs becomes effective, the regulations should specify what items are to be included in the development cost class and which in the exploration cost class. Any other expenditures not included in these classes should be deducted currently.

In the transitional period a 100 per cent rate of capital cost allowance would be applicable for both exploration and development costs so that there would be no need to distinguish immediately between such costs, which could be grouped into a single new capital cost allowance class that would be subject to a rate of 100 per cent. Unclaimed costs of exploration and development as at the effective date of the new legislation should also be included in this new capital cost allowance class. In the event of a reorganization under which all the underlying properties of a corporation were transferred, the undepreciated balance would likewise be transferred and the present limitations on the sale of unamortized costs should no longer apply. On the other hand, the taxation of property gains would mean that any gain on disposition would be taxable.

The above treatment should not apply to depreciable assets used in smelting and refining. These should continue to be subject to capital cost allowance at the regular rates for buildings and equipment.

Property Costs

Mining and petroleum properties are wasting assets which often have an indeterminate life. To be consistent with our recommendations for industry

generally, the costs of finding and maintaining mineral and petroleum reserves should be allowed as a deduction when incurred, while the cost of purchasing a property should be amortized over the life of the property if this is determinable or, if it is not determinable, the cost should only be deducted when a loss in value can be shown to have taken place. In the case of mining and petroleum properties it should usually be easy to demonstrate such a loss, for when a property proves unproductive or is closed down a loss in value would be established.

Because of the difficulties in estimating the amount of mineral and petroleum reserves with any degree of accuracy, it would not be feasible for tax purposes to attempt to match all of the costs of the property against the revenue produced. Rather, the exploration costs should be immediately deductible and the development costs should be amortized at an arbitrary rate, a procedure which would generally result in a faster write-off of costs than would otherwise be the case. In addition, the proposed rapid write-off provisions should also apply to the costs of acquiring property rights, even if subsequent exploration and development work was successful.

Accelerated write-offs assist the taxpayer to conserve internal sources of funds by deferring his tax liabilities, and therefore reduce the need for outside capital. However, in the case of the purchase cost of mining and petroleum properties an unlimited write-off, even for a transitional period, could have undesirable consequences. Not only would such a write-off be unduly liberal for the larger concerns, but it could well become a tax incentive to the larger companies to take over the smaller operations. If companies that were in a taxable position could immediately write off the full costs of acquiring a developed property, they would have a substantial advantage in the market for properties as compared to companies that were not yet taxable. Such an incentive would be particularly attractive to non-resident-owned companies, as integration would not apply to reduce the relative value of the immediate write-off.

In Chapter 22 we discuss a problem of a similar nature that is applicable to business in general. Although purchased goodwill and trade marks are intangible assets, while mining and petroleum properties are tangible assets, the problem of matching the revenue and related expenses is similar where the useful life and the quantity of reserves are indefinite in duration and amount. In principle, all the costs of developing or acquiring these items should be capitalized and then amortized so as to be matched with the revenue produced from the exploitation of the property. It is often difficult, if not impossible, to ascertain the useful life of each asset, for this depends upon the revenues that can be derived from it. The level of such revenues will be affected by many factors, usually beyond the control of the taxpayer. In Chapter 22 we recommend that all the costs of developing and maintaining such assets as goodwill and trade marks should be deductible in the year incurred, despite the fact that such costs should in principle be capitalized and amortized, but that the cost of purchased goodwill or trade marks should only be deducted when it could be demonstrated that a loss had occurred.

We will recommend a procedure for the mining and petroleum industries that will allow them to continue to receive more liberal treatment than other industries. Our proposals are as follows:

1. For companies qualifying under the new and small business provision the cost of mining and petroleum properties should be treated in the same way as is recommended for exploration and development costs, that is, allowed as a deduction when incurred up to a maximum of $250,000.

2. For other taxpayers the purchase cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The cost should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. While in the transitional period the proportion

might be up to 50 per cent, after a period of five to ten years it should be set at, say, 10 per cent to 20 per cent of the operating revenue from the property. A provision of this nature should not be difficult to administer as it should be possible to develop administratively feasible regulations defining what property costs were to be capitalized and how operating revenues were to be determined.

Any unamortized balance of the property cost should, of course, be allowed on the disposal or abandonment of the property or when it could be demonstrated that the property was valueless.

As a transitional measure, it perhaps should also be provided that the restriction on the write-off of property costs should not immediately apply to purchases of property rights from a government. The petroleum industry has had the right to an immediate write-off of the cost of such property rights since 1962 and to defer the deduction of these costs, while simultaneously withdrawing depletion, might be too great an adjustment for the larger integrated companies to make at one time. However, after, say, five years the limitations outlined above should be extended to all purchased properties.

Deduction of the costs of mining and petroleum property rights should differ in one respect from the usual procedures applicable to other costs included in capital cost allowance classes. A taxpayer acquiring a mining or petroleum property directly would capitalize the full costs, which would be amortized or written off as described above. A taxpayer acquiring a company that held such properties should not be permitted to adjust upward to market value the depreciable capital cost of the properties, as we have suggested he could do with other depreciable assets of the purchased company. Rather, the company should continue to claim capital cost allowance on the same basis as before the change in control and the excess of the purchase price of the shares over the undepreciated capital cost of the mining or petroleum property, if any, should in effect be regarded as goodwill. This procedure would create a bias between the purchase of shares and

the purchase of assets, but nevertheless would be necessary because of the difficulty of differentiating between the value of the properties and other intangibles such as goodwill.

Property Gains

We have recommended that property gains should be taxed in full (a procedure that is already applicable to petroleum properties), and that gains accrued prior to the date of implementation of our proposals should be excluded from income. However, in the case of mining and petroleum firms, we do not recommend that this exclusion should apply.

Our rejection of an exemption for gains unrealized at the transition date is dictated partly by tax avoidance considerations and partly by practical considerations. Experience at the time of the change in treatment of petroleum rights in 1962 indicated that, if petroleum properties could be sold tax free while the cost to the purchaser could be written off, many sales would probably take place for tax reasons and there would be an unacceptable loss in tax revenues. As a practical matter, it would be extremely difficult, if not impossible, to value many mineral properties. The allocation procedure suggested in Chapter 15 would be inappropriate because of the extreme fluctuations in the value of these properties over time, and because of the inhibiting effect that such a procedure would have on mobility. We discuss these difficulties later in this chapter.

In any event, the hardship which would result from the denial of the exemption is limited. For one thing, the general exclusion of gains accrued prior to the transition date should not apply to those taxpayers whose business included the realization of such gains. Also, all gains realized on the disposition of petroleum properties are already subject to tax. More important, the shareholders of a company holding property rights would not be subject to tax on the accrued property gains to the extent that such gains were reflected in the value of their shares at the transition date. Thus,

what would appear to be harsh treatment at the corporate level would be fully compensated for at the shareholder level as far as resident shareholders were concerned. Furthermore, in the case of prospectors, we recommend that some recognition should be given to the fact that their property gains are now tax free. In view of the difficulties in valuing mineral properties, the transitional provision for prospectors should provide for the taxation of such gains in stages.

We have recommended that all property gains should be taxed in full when realized. Thus, the disposal of any mining or petroleum property would be a taxable transaction; and the amount that would be amortizable to the purchaser would be an amount equal to the proceeds of disposition included in the income of the vendor. The taxation of the vendor's gains should produce much of the revenue to offset the write-off claimed by the purchaser. However, if the vendor was a non-resident while the purchaser was a resident, the liability to Canadian tax is not assured. We have expressed our belief that all gains realized on the disposition of Canadian property are a reasonable subject of Canadian tax. We have also stated that at the present time it is administratively impracticable or, in some cases, impossible to collect a tax on many such property gains—the prime example being the gains of non-residents on dealings in Canadian securities. On the other hand, we have recommended that gains and losses on the disposition of real property by non-residents should be included in income. Not only do we believe it is possible to administer such a provision, but also it is necessary to levy tax in these circumstances to avoid putting the Canadian holder of real property at a competitive disadvantage. These same considerations apply to mineral and petroleum rights and we therefore recommend that they be treated in the same manner as other interests in real property. Thus, the ownership in Canada of real property, or of an interest in real property, should be deemed to be a permanent establishment in Canada, with the result that any gain or loss on the disposition of such property or property interest would be taken into account in computing Canadian source business income.

Deduction for Shareholders

In order to ensure that the benefits of the proposed rapid write-offs accrue to the small and medium-sized companies as well as to the integrated operations, we recommend that an option be available to mining and petroleum companies to pass on to the purchasers of new shares the right to the immediate deduction of exploration and development costs. This transfer would be accomplished by permitting the purchasers of the newly issued shares to write down the cost basis of such new shares to the extent that the proceeds of the issue were to be spent on exploration and development. This reduction in the cost basis, which would produce a "loss" that could be deducted from other income, would be allowed at the time of the investment even though the costs would not then have been incurred by the mining or petroleum company. When the company did incur the costs they would not, of course, be available as a deduction to the company and as a result corporation income tax would become payable at an earlier date. The tax authorities should establish certain controls to ensure that the company did in fact expend the funds on exploration and development. For example, a trust account might be required and a special tax might be imposed on any part of the designated funds that had not been spent on exploration and development within the period specified. It is not intended that costs of financing or administration would be included in this special write-off, but only the direct costs of exploration and development. This provision should be applicable to new share issues only, and not to outstanding shares. It should greatly facilitate the raising of risk capital by independent exploration companies and put them on essentially the same basis as the larger integrated corporations. Also, it should help to equalize the positions of the large and small companies as regards their ability to utilize the liberal write-off provisions that we have proposed.

Taken together, these proposals would virtually preclude the possibility of incomplete loss-offsets for expenditures in mining and petroleum exploration

and development. The large successful companies would deduct their costs of unsuccessful ventures from other business income. The newly issued shares of corporations that did not have operating income would, if the corporation made the election outlined above, immediately be eligible for a write-down to the extent of exploration and development expenses. The shareholders could immediately offset these expenditures against other income. The shares of corporations with inadequate operating income that for some reason did not follow the immediate write-down procedure would decline in price if the market judged the venture to be unsuccessful. The shareholder could then write down the value of his shares to market value. With all of these methods available for deducting losses from other income, we are satisfied that the tax system would not be biased against risk taking in the mining and petroleum industries.

Undeducted Property Costs

Although we have proposed some measures to reduce the impact of withdrawing percentage depletion, we believe that an additional transitional provision is required. As depletion was at least in part intended to compensate for non-deductible costs, and as substantial costs have been incurred in the expectation that any income would be eligible for a depletion allowance, some recognition should be given to costs that have not yet been absorbed. Therefore, we recommend that mining and petroleum operations that are now eligible to claim depletion should be able to deduct (over, say, a three- or five-year period) all costs of exploration and development which were not deductible in the past, including the cost of mining and petroleum properties, leases and licences, to the extent that such costs exceeded the amount of depletion claimed. This provision should only apply to costs incurred in Canada and depletion claimed over a certain number of years. As the deductibility of exploration and development costs was considerably expanded in 1948, this might be an appropriate year from which to begin the determination. The computation should be applied to associated companies on a consolidated basis.

The unclaimed costs of properties for petroleum companies are probably between $500 million and $750 million 26/. These companies claimed depletion between 1947 and 1964 of over $350 million, so that a provision of this nature would probably result in an amount of about $300 million becoming deductible by petroleum companies. The amounts of unclaimed costs would not be as large for mining companies, which have claimed depletion over this period in excess of $1,000 million. Thus, most of the benefit of such a write-off would accrue to those mining companies that had claimed little or no depletion.

Prospector and Grubstaker Exemption

There remains no justification for exempting the profits of prospectors and grubstakers from full rates of personal income tax. With the full deductibility of costs, with the averaging provisions recommended elsewhere in the Report, and with the provisions suggested later in this chapter to ameliorate any liquidity problems that would arise when property rights were exchanged for a non-cash consideration, the exemption can be withdrawn without hardship. However, the withdrawal should perhaps be implemented in stages over a transitional period, because we recommend that any properties held at the transition date by an individual prospector should be valued at his cost so as to obviate the problem of determining a market value.

Shareholder Depletion

With the full deduction of all costs, it would not be necessary to provide shareholders with an allowance for the depletion of their "capital". Accordingly, the provision for shareholder depletion should be repealed.

Special Aspects of the
Proposed Tax Treatment

We now turn to certain special aspects of mineral and petroleum operations: the treatment of costs of exploration outside Canada, payments to the provinces for petroleum rights and mining taxes, the purchase and sale of

mining and petroleum rights and properties, and the application of the proposed incentives to particular types of taxpayers.

Exploration Outside Canada. Under the present legislation, the costs of exploring for minerals and petroleum outside Canada are generally not deductible. This disallowance was probably adopted in the past to encourage the development of Canadian resources and to obviate any tax avoidance opportunities which their deduction might have created. Such an opportunity might have arisen, for example, in circumstances where a taxpayer resident in Canada deducted the costs of foreign exploration and then, in order to escape Canadian tax on any resulting profits, transferred the income-producing property to a company in a low tax jurisdiction.

The allowance of these costs is a desirable step if the measurement of income from mineral and petroleum extraction is to be improved, and we therefore recommend that these expenses be made deductible. It may be necessary to enact provisions which would require a resident company which transfers a property to a non-resident to include in its income at least the fair market value of the property transferred. Having regard to the provisions we recommend for deemed dispositions and the taxation of income from direct investment abroad, we are of the opinion that the problem of avoidance should not be a serious barrier to the allowance of these costs.

Payments to the Provinces. A continuing problem over the years has been the determination of what is a reasonable allowance under federal taxation for the various levies on natural resources imposed by the provinces. Where a province has retained proprietary rights in natural resources under the British North America Act, it may levy a charge in compensation for relinquishing those rights. In effect, it may sell its natural resources at a reasonable price. Any province may also exercise its constitutional powers to impose a direct tax on the exploitation of any natural resource, whether or not the province retains a proprietary interest in the resource. Such a direct tax may be imposed in addition to the natural resource charge, because

the legislative powers of the provinces in respect of property and taxation are not mutually exclusive.

Normally, the proprietary cost is recognized through a charge based on the quantity and quality of the resource depleted; typical examples are the stumpage charges in the forestry industry and the royalty charges for petroleum. These are normally recognized without question by the federal authorities as being allowable expenses of the taxpayer.

The provinces, particularly Alberta, have obtained substantial revenues from their oil resources by charging operators, by way of initial payments and annual charges and royalties, for rights to take oil 27/.

Royalties have always been allowable as a deduction in computing income for tax purposes, but payments for rights to take the oil were deductible only to a limited extent prior to 1962. When the cost of these rights became fully deductible in 1962, oil producers could afford to pay higher prices for the rights; consequently, a major effect of the change was to increase the prices of such rights and thereby transfer from the federal to the provincial treasury some of the government revenues from oil resources.

The provinces have had little difficulty in exercising their right to revenue from petroleum, probably because of such inherent characteristics as its homogeneous nature and the fact that the market value is relatively easy to establish. Because petroleum has an established value at the well-head, it would be somewhat easier than in the mining industry to determine the income from the actual extraction of petroleum and to levy a tax thereon. The provinces, however, have not thought it desirable to apply to the petroleum industry an income tax comparable to the mining tax, but rely on a royalty based on barrels of production.

Originally, the provinces derived revenue from mining by levying a flat charge per ton of ore removed. Most provinces now obtain their main revenues from mining through a tax on mining income—although the

provincial revenues from mining are much less than one half of those derived from petroleum. While simple in theory, the determination of the meaning of mining income for tax purposes has given rise to certain complications. Elaborate definitions have been devised to formulate a method of determining such income, the general purpose being to establish a concept of income earned in extracting the ore and raising it to the surface. In some cases this is done by direct computation; in others by a calculation to eliminate from the total profits of the operation the profit made on milling and processing. The federal government has its own definition governing the sort of tax it will recognize as being deductible and, while most of the provinces adhere fairly closely to this definition in levying their charges, there are some troublesome differences in the treatment of certain factors in the computation. The most serious differences arise in the case of the Quebec tax which is levied on a broader base than is contemplated in the federal definition.

Whether the provincial governments derive revenues from natural resources through lease payments, royalties, or a tax on income, the charges are nevertheless a cost of acquiring a supply of the mineral or petroleum concerned. Therefore, such charges, regardless of their form, should be deductible in full in the computation of income in the same way as any other cost of doing business. However, as they are a cost of earning income, they should not be eligible for any form of tax credit.

Purchase and Sale of Mineral and Petroleum Rights and Properties. A mining or petroleum property may pass through many hands before being developed. In the case of mining property, a typical chain of events for a discovery not made by a major mining company is that a prospector first stakes a property and, having done some work on it, enters into an agreement with an exploration company under which the company, in consideration for an interest in the property, undertakes to investigate the property. If the investigation warrants it, the exploration company does some development work on the property and interests a major mining company in financing it to a producing

state. At this stage a new company is formed in which the prospector, the exploration company and the mining company each have an interest. Usually, throughout this chain of events, little or no cash changes hands between the parties and frequently no price is stipulated when the property passes from one owner to another. Each party takes or retains an interest in the property either in the form of rights to participate in net income from production or shares in a company controlling the property.

Transactions also occur in mining properties that have been fully developed or are in production, but these are not nearly as common as transactions in proven or producing oil properties.

In general, the proceeds from the sale of mining properties by prospectors or grubstakers would probably be considered taxable, but specific exemption is at present provided in section 83(2) of the Income Tax Act. Mining properties that have been developed or are in production are normally considered capital assets, and any proceeds from their sale are non-taxable except to the extent of recaptured depreciation unless the vendor is found to be dealing in mining properties. There is no recapture of exploration and development costs that have been claimed and are subsequently recovered upon sale of the mining property. Circumstances in which pre-production expenditures can be transferred between taxpayers are referred to below.

Thus, while the present system ignores purchases and sales of mining properties, the actual costs of exploration for and development of mining properties are generally recognized, either as deductions against other income of the taxpayer incurring the costs or, under certain conditions which will be discussed in more detail below, by transfer to other taxpayers. The important exceptions to this general statement are prospectors and grubstakers and the exploration companies and mining companies that themselves have insufficient income to absorb such costs and are unable to enter into transactions that would enable the costs to be transferred to other taxpayers.

The present system is inequitable and contrasts sharply with our recommended basis for determining business income. Certain anomalies and loopholes have incidentally been created. In this connection, we have already proposed that all the costs of acquisition and development of mining rights should be allowable, and it would follow that any proceeds attributable to these activities should be included in income.

The main difficulty in introducing a system under which the purchase and sale of mining properties would be taxable transactions lies in placing a value on the consideration, most of which would usually be in the form of shares. There are several alternative methods of valuation:

1. Fair market value might be adopted as the measure of the consideration. In some cases information would be available as to the value of the shares, but often there would be no adequate indication of value for several years. It does not seem practicable to wait a number of years to establish the value.

2. Only the cash consideration might be recognized for tax purposes. This would make for greater certainty, but would be inequitable when so little of the consideration would usually be paid in the form of cash. It would also invite artificial avoidance procedures.

3. Only the costs related to the property that were not yet claimed by the vendor might be regarded as consideration for tax purposes. This treatment would give recognition to the fact that many transactions in mining properties are steps in a continuous chain of events resulting in the emergence of operating income. It would not serve equity, however, where the fair market value was considerably in excess of the cost.

Despite the practical difficulties involved, we recommend, with the exception noted below, that the purchase and sale of mining properties be treated as taxable transactions. It follows that the present exemption of amounts realized by prospectors and grubstakers from the sale of mining

properties should be discontinued and that any costs which they have incurred should be allowed. The general basis of valuing transactions in mining properties should be fair market value, although in certain circumstances the use of the unclaimed costs of the vendor would be acceptable. Where a mining property was exchanged for shares in a new company that were not publicly traded or for shares that were publicly traded but represented an interest in a company of more than 25 per cent, we recommend that the vendor of the property should be permitted to adopt as the cost basis of the shares an amount equal to his unclaimed costs. This would mean that no profit would be recognized for tax purposes at the time of transfer. Under our proposed treatment of losses, any decline in the value of the property or shares could be taken into account whenever such loss could be established. In Chapter 15 it is also recommended that a disposition of the shares received in exchange for property should be deemed to take place when the shares satisfy two conditions: they represent an interest in the company of 25 per cent or less, and are publicly traded.

We have already noted that in 1962 fundamental changes were enacted in the tax laws applicable to the petroleum industry. The cost of oil rights and properties became a deductible expenditure, and the proceeds from disposal of all petroleum properties, regardless of their date of acquisition, became taxable. However, the costs of properties acquired prior to the effective date were not deductible. Representations have been made to us concerning this anomalous result, and accordingly further comment is appropriate.

Originally, it was proposed that the proceeds from the sale of any property acquired prior to April 11, 1962, would not be taxable, a procedure that would have followed the more or less traditional approach of avoiding retroactive taxation of amounts that were previously exempt. However, since the cost of any property acquired after that date was to be immediately deductible, there arose the possibility that taxpayers would exchange

properties at high prices to their mutual tax advantage, creating capital gains for the vendors and deductible costs for the purchasers. Because of the way in which oil fields are shared by companies, it soon became evident that this potential avoidance technique was an actual one. Accordingly, when the changes were finally enacted it was provided that the proceeds of the disposal of all oil properties not acquired by inheritance would be included in income unless they were acquired before April 11, 1962, and disposed of before November 9, 1962. 28/

Actually, the taxation of proceeds from the disposition of properties acquired prior to April 11, 1962, has probably had a limited retroactive effect as the purchaser, now that the cost of acquisition is deductible at some time, can afford to pay a much higher price and thereby leave the vendor in almost the same net position as before. It has also been contended that the impact of tax on the profit from dispositions of oil properties has been such as to discourage transactions from actually taking place. However, the size of the tax impact is a reflection of the fact that a property may be carried at a much lower tax value than its real value. When a taxpayer actually realizes this difference, the government must collect the full tax at that time. It is the consequence of taxing income on a realized basis and allowing accelerated write-off of costs.

The denial of a deduction for the cost of properties acquired prior to April 11, 1962, is of more concern. However, as part of our recommended transitional provisions we have suggested that the excess of these unclaimed costs over depletion claimed should become deductible, and therefore in effect all costs would be deducted in one manner or another.

Application of Mining and Petroleum Provisions to Particular Types of Taxpayers. Under the present legislation considerable complexity is caused by the fact that provisions for the taxation of mining and petroleum income apply to different taxpayers in different ways, primarily according to the principal business conducted by the taxpayer, but also according to whether the taxpayer is an

individual or a corporation. Many of the provisions presumably were intended as incentives available only to persons in mining and petroleum. This policy does not generally appear to be valid. It is therefore recommended that the limitations on the availability of the special provisions be removed. An incidental and important effect of this change should be to encourage wider participation by Canadians in the mining and petroleum industries.

Proposed Tax Treatment of the Mining and Petroleum Industries Compared with the Proposed Tax Treatment of Other Industries

The effects of our proposals on the mining and petroleum industries, relative to the present treatment of these industries and relative to the proposed treatment of other industries, can be shown in tabular form. Table 23-1 deals with the treatment of costs; Table 23-2 deals with the treatment of losses.

The outstanding features of the recommended changes in the treatment of costs can be briefly stated:

1. All costs would be deductible at some time for all industries.

2. The mining and petroleum industries would be allowed an immediate write-off of all exploration costs and initially of all development costs, with the exception of depreciable assets used in smelting and refining (although the new and small business provision applicable to all industries would also apply to mining and petroleum).

3. The purchase cost of mining and petroleum properties and property rights could be amortized, initially at a rapid rate and later at a more moderate rate. The cost of abandoned or valueless properties could, of course, be written off when the loss in value was shown to have occurred.

TABLE 23-1

COMPARISON OF PRESENT AND PROPOSED TREATMENT OF COSTS FOR MINING AND PETROLEUM WITH COMPARABLE COSTS OF OTHER INDUSTRIES

Type of Cost		Present Treatment		Proposed Treatment	
Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum
Research and product development	Prospecting and exploration	Current and capital costs for scientific research—immediate write-off a/ Other current costs—immediate write-off Other capital costs—no write-off unless under capital cost allowance provisions	Immediate write-off	Immediate write-off	Immediate write-off including special write-off for holders of newly issued shares
Inventory	Development costs (including forward development)	Charged against income when goods sold or on a loss in value	Generally immediate write-off	Charged against income when goods sold or on a loss in value	Immediate write-off during initial period—capital cost allowance at 20 per cent to 30 per cent thereafter, also special write-off for holders of newly issued shares
Patents copyrights and goodwill	Property rights	Fixed life—amortized over life Other—not deductible	Petroleum—immediate write-off Mining—not deductible b/	Fixed life amortized over life Other—deductible when lost or reduced in value	Amortized as a percentage of revenues from the property or written-off on a proven loss in value
Depreciable assets	Depreciable assets: a) used in prospecting, exploration, extraction and reduction b) used in smelting and refining c) unclaimed capital costs on effective date	Immediate write-off for assets used in scientific research—otherwise capital cost allowance rates	Capital cost allowance rates	Immediate write-off for assets used in scientific research. On other assets capital cost allowance rates unchanged except for small and new businesses	a) Immediate write-off b) Unchanged except for small and new businesses c) Unchanged

Notes:

a/ Until the end of the 1966 year an additional 50 per cent is also deductible.

b/ Depletion is sometimes regarded as a roughly equivalent deduction.

TABLE 23-2

COMPARISON OF PRESENT AND PROPOSED TREATMENT OF LOSSES
FOR MINING AND PETROLEUM WITH OTHER INDUSTRIES

		Present Treatment		Proposed Treatment	
Type of Loss	Principal Features of Treatment	Industry Generally	Mining and Petroleum	Industry Generally	Mining and Petroleum
Business losses	Carry-back	1 year	Same as industry generally	2 years	Same as industry generally
	Carry-forward	5 years		No limit	
	Deductible from other kinds of income	All income in year of loss—business income in other years		No limit a/	
	Transferability	Restricted		Restricted but this is largely irrelevant because losses on shares deductible as described below	
Losses on shares	Carry-back Carry-forward Deductible from other kinds of income	Not deductible	Not deductible	Same as treatment of business losses	Same as industry generally
	Write-down to market without realization	Not deductible	Not deductible	Deductible	Deductible

Note:

a/ Except for limitations to preclude deduction of personal expenditures.

4. The mining and petroleum industries would therefore be allowed to write off the following kinds of costs more rapidly than industry generally would be allowed to write off costs of a comparable type:

   a) pre-production and development costs;
   b) the cost of depreciable assets used in exploration and development; and
   c) the purchase cost of mining and petroleum properties and property rights.

5. The mining and petroleum industries would be better off under our proposals than they are at present so far as the treatment of costs is concerned; the major advantage would be enjoyed during the initial period when development costs could be written off when incurred.

6. New mining and petroleum companies that met the asset and sales qualifications for new and small businesses would be entitled to an immediate write-off of all depreciable assets within liberal limits. In addition, the newly issued shares of mining and petroleum companies would be eligible for a special write-off to the extent that the proceeds of the share issue were to be expended on exploration and development.

The outstanding features of the recommended changes in the treatment of business and property losses are set forth in Table 23-2.

1. The treatment of business losses would be liberalized for all industries in the following respects:

   a) the carry-back of losses would be extended from one to two years;
   b) the five-year limit on the carry-forward of losses would be removed;
   c) business losses could be used to offset other income of the individual in any year of loss or any other year in which the loss could be carried back or forward;

d) limitations on the transferability of losses would remain, but because property losses would be deductible to shareholders the significance of the restriction would be much reduced.

2. Share losses for all industries would be treated in the same way as other property losses; under the present system share losses are not deductible because the gains are not taxed.

Effect of the Proposed Tax Treatment

It is difficult to make precise estimates of the overall effects of our proposals on the after-tax rate of return from mining and petroleum companies. The impact of the recommended changes would depend upon many circumstances that would differ substantially from company to company. It is useful, however, to cite the following estimates from a study prepared for us 29/. These estimates, as given in Table 23-3, are based on simplified assumptions that are set forth in the study and do not purport to represent any particular company. Rather, they show the position of a "typical" company under hypothetical but reasonable conditions. Estimates have been prepared for both hypothetical mining companies and hypothetical petroleum companies. Because of the different assumptions made for the two industries, estimates of the rates of return are not comparable between the two, but are comparable within each industry.

Although we freely acknowledge that these indices are subject to severe limitations and must be interpreted with caution, they reflect the general orders of magnitude involved. The data in Table 23-3 suggest that:

1. Because of the incentive element built into the capital cost allowance rates generally, corporations in all industries have a higher after-tax cash flow rate of return than they would have with a "pure" accounting concept of income (Index 2 compared to Index 1).

2. The proposed treatment of mining and petroleum companies would provide a substantially higher after-tax cash flow rate of return than that proposed for other industries (Index 3 compared to Index 2).

TABLE 23-3

INDICES OF THE AFTER-TAX CASH FLOW RATE OF RETURN TO A CORPORATION ON INVESTMENTS IN PETROLEUM AND MINING UNDER HYPOTHETICAL CONDITIONS AND ALTERNATIVE TAX TREATMENTS

Tax Treatment	Petroleum	Mining
1. Complete matching of costs and revenues over a period of time, with no percentage depletion or three-year exemption. This is a "pure" accounting concept of income.	100.0	100.0
2. Exploration and development expenses in a 30 per cent capital cost allowance class.	119.0	121.4
3. Proposed initial treatment for mining and petroleum a/.	151.6	147.5
4. Present treatment b/		
a) integrated company—i.e., one with operating income to offset all exploration and development costs.	196.7	165.9
b) non-integrated company—i.e., one without operating income other than from the particular mine or oil well.	141.0	150.5

Notes:

a/ The index for petroleum is higher than that for mining because of the relatively greater importance in petroleum of the cost of property rights. Thus, an accelerated write-off of such costs is of more value to petroleum companies. The indices for both petroleum and mining reflect our proposals for the transitional period, and therefore are slightly higher than what might be expected when the costs of development and of property rights are not written off immediately or at a 50 per cent rate but are amortized over a period of years.

b/ In Bucovetsky's study a period of 25 years was employed for the petroleum and 15 years for the mining examples. Because the depletion allowance becomes more valuable once all the costs of exploration and development have been written off, a longer time period increases the relative value of the present concessions. Thus, the index of 165.9 for mining would be an understatement of the position of a mine with a longer life.

Source: Bucovetsky, The Taxation of Mineral Extraction, Appendices E and F.

1. Petroleum Case 12; Mining Case 14.
2. Petroleum Case 15; Mining Case 17.
3. Petroleum Case 14; Mining Case 13.
4. Petroleum Case 3; Mining Case 2.
5. Petroleum Case 1; Mining Case 1.

3. The after-tax cash flow rate of return to petroleum companies with operating income would be reduced by our proposals by about 23 per cent; 30/ the cash flow rate of return to petroleum companies that now cannot offset exploration and development expenses would be raised by 5 per cent to 10 per cent (Index 3 compared to Indices 4 and 5).

4. The after-tax cash flow rate of return to mining companies with operating income would be reduced by about 11 per cent; the after-tax cash flow rate of return to mining companies without adequate operating income to provide a full offset would decline about 2 per cent (Index 3 compared to Indices 4 and 5).

The integrated company would be subject to the most unfavourable change at the corporate level, as shown by the indices of after-tax cash flow of rates of return in Table 23-3. Despite the substantial reduction in after-tax corporate income for integrated petroleum companies that would follow from the implementation of the recommended tax treatment for the petroleum industry, the compensating effects of integration at the shareholder level would largely offset, for Canadian shareholders receiving dividends, the increased burden at the corporate level. This is demonstrated in the example given in Table 23-4 which compares the respective positions of Canadian shareholders who receive dividend income from an integrated company and who are subject to tax at marginal rates of 50 per cent and 30 per cent under the present and proposed systems. Clearly, shareholders at the higher income levels are not absolutely worse off and at the lower income levels are absolutely better off.

However, the hypothetical example given in Table 23-5 illustrates that the favourable effects of integration do not offset, for resident shareholders in integrated companies, the negative effects of both the corporation tax changes with respect to petroleum companies and the full taxation of share gains. On the other hand, Table 23-6 illustrates that low and middle income resident shareholders in non-integrated companies would have their

TABLE 23-4

AFTER-TAX DIVIDEND INCOME OF A CANADIAN SHAREHOLDER IN AN INTEGRATED PETROLEUM CORPORATION—COMBINED EFFECT OF PROPOSED CHANGES IN TAX TREATMENT AT THE CORPORATE LEVEL AND INTEGRATION OF CORPORATION AND PERSONAL TAX

	Present Treatment	Proposed Treatment
Corporation		
Assumed after-tax corporate income based upon the indices in Table 23-3 a/	$100.00	$ 77.00
Shareholder with a 50 per cent marginal rate		
Dividend (assuming 100 per cent distribution)	$100.00	$ 77.00
Personal Tax at 50 per cent	-40.00 b/	-77.00 c/
Tax Credit d/	+16.00	+77.00
After-tax dividend income to shareholder	$ 76.00	$ 77.00
Shareholder with a 30 per cent marginal rate		
Dividend (assuming 100 per cent distribution)	$100.00	$ 77.00
Personal tax at 30 per cent	-24.00 b/	-46.20 c/
Tax credit d/	+16.00	+77.00
After-tax dividend income to shareholder	$ 92.00	$ 107.80

Notes:

a/ If an index of 196.7 equals $100.00, then the index of 151.6 equals $77.00. The difference in the income figures reflects the removal of the depletion allowance but does not take into consideration any write-off of old exploration and development costs that would be deductible under the proposed transitional provisions.

b/ Personal tax computed as follows:

Dividend	$100.00
Less shareholder's depletion at 20 per cent	-20.00
Net dividend taxable	$ 80.00
Personal tax at 50 per cent	$ 40.00
Personal tax at 30 per cent	$ 24.00

c/ Personal tax is levied on the grossed-up amount

$$\left(\text{i.e.}\quad \$77.00 \times \frac{100}{100 \text{ minus corporation tax rate}}\right)$$

d/ The tax credit at present is the dividend tax credit of 20 per cent of the net dividend after depletion, while under the proposal it would be the credit for the corporation tax paid.

TABLE 23-5

EFFECT OF THE PROPOSED TAX CHANGES—BOTH CORPORATE AND PERSONAL AND INCLUDING TAXATION OF SHARE GAINS—ON THE AFTER-TAX RATE OF RETURN FROM A HYPOTHETICAL INTEGRATED PETROLEUM CORPORATION TO A CANADIAN SHAREHOLDER WITH A MARGINAL PERSONAL TAX RATE OF 30 PER CENT

		Present		Proposed
Corporate after-tax income per share		$100.00		$ 77.00 a/
Cash retained by corporation b/		50.00		38.50
Dividend to shareholder		$ 50.00		$ 38.50
Personal tax at 30 per cent		-12.00 c/		-46.20 d/
Dividend tax credit (present) or tax rebate (proposed)		8.00 c/		77.00 e/
After-tax cash income to shareholder		$ 46.00		$ 69.30
Assumed share gain: f/				
from retention	$50.00		$38.50	
from goodwill	50.00	100.00	38.50	77.00
Personal tax on share gains		-		-11.55 g/
Total after-tax return to shareholder h/		$146.00		$134.75

Notes:

a/ It is assumed that changes in the tax treatment at the corporate level reduce after-tax corporate income by 23 per cent. (See Table 23-4.)

b/ It is assumed that retained earnings are one half of after-tax corporate earnings.

c/ Personal tax is computed as follows:

Dividend	$ 50.00
Less shareholder depletion at 20 per cent	10.00
Net dividend taxable	$ 40.00
Personal tax at 30 per cent	-$ 12.00
The dividend tax credit is 20 per cent of $40.	-$ 8.00

d/ It is assumed that all corporate income is allocated to the shareholder so that the shareholder would bring into income $154.00 (the grossed-up figure for $77.00 of after-tax income) and would be subject to a 30 per cent tax on this amount.

e/ Full credit for the corporation tax paid.

f/ It is assumed that share gains are double retained earnings per share (and therefore that "goodwill" capital gains are equal to retained earnings). A higher ratio of goodwill gains to retained earnings would further improve the relative after-tax return of the present system as compared to our proposals.

g/ Because of the upward adjustment of the cost basis by the amount of the retention, the share gain resulting from the retention would not be subject to tax to the shareholder. It is assumed that the goodwill property gain is realized.

h/ For a shareholder subject to a personal rate of tax of 50 per cent the comparable figures would be $138.00 at present and $96.25 under the proposal.

TABLE 23-6

EFFECT OF THE PROPOSED TAX CHANGES—BOTH CORPORATE AND PERSONAL AND INCLUDING TAXATION OF SHARE GAINS—ON THE AFTER-TAX RATE OF RETURN FROM A HYPOTHETICAL NON-INTEGRATED PETROLEUM CORPORATION TO A CANADIAN SHAREHOLDER WITH A MARGINAL PERSONAL TAX RATE OF 30 PER CENT

		Present		Proposed
Corporate after-tax income per share		$100.00		$100.00 a/
Cash retained by corporation b/		50.00		50.00
Dividend to shareholder		$ 50.00		$ 50.00
Personal tax at 30 per cent		-12.00 c/		-60.00 d/
Dividend tax credit (present) or tax rebate (proposed)		8.00 c/		100.00 e/
After-tax cash income to shareholder		$ 46.00		$ 90.00
Assumed share gain: f/				
from retention	$50.00		$50.00	
from goodwill	50.00	100.00	50.00	100.00
Personal tax on share gains		-		-15.00 g/
Total after-tax return to shareholder h/		$146.00		$175.00

Notes:

a/ It is assumed that changes in the tax treatment at the corporate level do not have any net effect on after-tax corporate income. Table 23-3 indicates that the proposed treatment would not vary greatly from the present situation. As depletion is of little value to the non-integrated company, the improvement in write-offs is sufficient to offset its removal. On the other hand, for those companies that permitted their shareholders to take advantage of the special write-off on newly issued shares, the proposed tax treatment would improve their position over what presently exists. For these companies the assumption of an unchanged corporate after-tax income would be conservative.

b/ It is assumed that retained earnings are one half of after-tax corporate earnings.

c/ Personal tax is computed as follows:

Dividend	$ 50.00
Less shareholder depletion at 20 per cent	10.00
Net dividend taxable	$ 40.00
Personal tax at 30 per cent	-$ 12.00
The dividend tax credit is 20 per cent of $40.	-$ 8.00

d/ It is assumed that all corporate income is allocated to the shareholder so that the shareholder would bring into income $200.00 (the grossed-up figure for $100.00 of after-tax income) and would be subject to a 30 per cent tax on this amount.

e/ Full credit for the corporation tax paid.

f/ It is assumed that share gains are double retained earnings per share (and therefore that "goodwill" capital gains are equal to retained earnings). A higher ratio of goodwill gains to retained earnings would improve the relative after-tax return of the present system as compared to our proposals.

g/ Because of the upward adjustment of the cost basis by the amount of the retention, the share gain resulting from the retention would not be subject to tax to the shareholder. It is assumed that the goodwill property gain is realized.

h/ For a shareholder subject to a personal rate of tax of 50 per cent the comparable figures would be $138.00 at present and $125.00 under the proposal.

positions improved by our proposals, unless the capital gain element was a substantial proportion of their total investment return.

While the negative effects of the proposed tax treatment of companies with operating or refining income would be greater than for other companies in the extractive industries, we acknowledge that the position of a substantial proportion of resident shareholders of Canadian mining and petroleum corporations would be less favourable than it is now. Non-resident shareholders would not benefit from the integration proposal, and therefore to the extent that the additional Canadian tax was not eligible for foreign tax credit their position would be worsened even more substantially. This is an unfortunate but inescapable result of removing an inefficient concession. Unless we are willing to accept the existing tax system as immutable, we must also accept undesired windfall gains and losses. They are the inescapable concomitants of change.

Our recommendations would have a greater revenue impact on the mining industry than on the petroleum industry. The amount of depletion claimed by the mining industry is more than double that claimed by the petroleum companies, although three petroleum companies are included in the eight companies that, in 1964, together accounted for about 85 per cent of the total depletion claimed by all mining and petroleum companies. In addition, the removal of the three-year exemption for new mines would be applicable only to the mining industry and would produce about the same increase in tax revenues as the elimination of depletion. Again, the largest companies would be subject to the greatest impact, as is demonstrated by the fact that, in 1964, four mining companies accounted for over three quarters of the exempt income under this provision.

The question that then arises is whether the removal of the major concessions would have a serious impact on the activities of the larger companies. In seeking the answer, we reviewed the operating figures of a number of companies to compare their position with what it would have been

if our proposals had been in effect. A review of four large iron ore mining companies, which together have claimed approximately $250 million in exempt income under the three-year provision, indicated that under our recommended procedures they would on average still not pay any income taxes until they had been producing for over ten years. This is somewhat more than a year earlier than would have been the case under the present system. The major difference is that under our proposals it would have been necessary to claim substantially all of the capital cost allowance available in order to eliminate their taxable income. In any case, the accelerated write-offs would mean that tax liabilities could be deferred for a considerable period of time, and certainly could be deferred until the total financing obtained to put the mines into production had been repaid. We do not believe that a procedure for computing taxable income that would have deferred the payment of income taxes for over ten years would have prevented the development of an economically feasible project.

Another interesting example of the impact of the present concessions is provided by some of the uranium mining companies. The major uranium producers up to 1964 had produced and sold over one billion dollars worth of ore from mines that represented a capital investment of under a quarter of a billion dollars. After retiring all debts and writing off the whole investment, they realized about a quarter of a billion dollars of which somewhat less than one half was paid out in dividends. After deducting exempt income and depletion, the total income tax liability (including taxes paid by shareholders) was under $30 million, or about 10 per cent of the profits. Under our proposals the tax liability would have been about the same, but all of their capital cost allowances would have been claimed. Thus, their future taxes would be substantially higher, but this fact would not have precluded the development of any of these mines.

Finally, we reviewed the operating figures for the past three to ten years for a number of large integrated mining and oil companies. The average

total taxes paid on income before tax and before depletion, including an estimate of the income taxes paid by shareholders on dividends received, was just over 40 per cent. The mining companies were taxed at less than this rate because of the three-year exemption (one large mining company in particular paid taxes at a substantially lower rate). We estimate that under our proposals the average tax rate applicable to all corporate source income attributable to Canadian residents would be substantially less than 40 per cent. Therefore, the Canadian shareholders in mining and petroleum companies would experience a reduction in the total income tax liability on their portion of the corporate profits of these companies. Non-resident shareholders in these companies would experience an increase in the Canadian tax on their portion of the profits. Canadian shareholders would, however, also be subject to a tax on share gains at full personal rates and so would pay tax on gains at a level that would be higher than that faced by non-residents. Consequently, the total taxes paid by a substantial proportion of the Canadian investors in mining and petroleum companies would be increased.

We have emphasized that the small and medium-sized mining and petroleum companies obtain very little direct benefit from these two major tax concessions. We have pointed out that a major purpose of such special tax concessions is to offset a capital market bias that is presumed to exist. However, we do not believe that the larger companies experience any unusual difficulties in financing their operations and therefore, from this point of view, the concessions are misdirected. For the small and medium-sized companies, we feel that the proposed rapid write-offs of exploration and development costs, and the special write-off for new shares issued to finance exploration and development, would be at least as beneficial as the present concessions. Further assistance to such companies, if it is required, would be best directed to them in the form of exploration subsidies and assistance in meeting transportation and other special costs.

CONCLUSIONS AND RECOMMENDATIONS

1. The present Income Tax Act contains special provisions for the mining and petroleum industries. The most important of these provisions are:

   a) the immediate deduction of exploration and development costs by qualified corporations against income from any source with an indefinite carry-forward of such costs not written off;
   b) the three-year exemption of income from new mines;
   c) the deduction of a proportion of the income from oil, gas and mining operations as an allowance for depletion, which is permitted to oil, gas and mining companies and their shareholders.

2. These special provisions have probably brought about an increase in the allocation of labour and capital to mineral and petroleum extraction in Canada. Whether there is a net gain in economic well-being from this diversion of labour and capital from other uses to mineral and petroleum extraction, and whether the same result could be achieved at lower revenue cost, are the crucial questions.

3. The treatment of business income generally in the present Act is seriously deficient in three respects that are relevant for the taxation of the mining and petroleum industries:

   a) some costs laid out to earn income are not deductible at any time;
   b) restrictions on the deduction and transferability of business losses create a bias against risk taking; and
   c) some net gains are excluded from business income.

   To the extent that the mining and petroleum industries are more adversely affected by (a) and (b) than industry in general, and to the extent that (c) is less advantageous for the extractive industries than for industry generally, the special provisions for mining and petroleum have some justification in the context of the present tax system.

4. The adoption of the recommended changes in the treatment of business income generally would virtually eliminate all of the features of the present system that justify special concessions to the extractive industries either through percentage depletion or the three-year exemption for new mines. Specifically:

a) all costs of earning income would be deductible;

b) the limitations on the carry-forward, carry-back, deductibility and transferability of losses would be either substantially reduced or made much less important; and

c) virtually all net gains would be taxed on the same basis.

ARGUMENTS FOR SPECIAL
TAX CONCESSIONS

5. We accept the argument that, because of the uncertainty of the return on outlays for mineral and petroleum discovery and extraction, a more rapid write-off of costs is required to achieve tax neutrality between the mining and petroleum industries and other industries. The recommended changes in the provisions for the mining and petroleum industries reflect this acceptance.

6. We accept the view that, unless losses are accorded treatment that is similar to that given to gains, the tax system is biased against risk taking. (Equality of treatment could be achieved only with unlimited tax refunds on business losses.) The proposed treatment of business and property losses would virtually eliminate this bias for all businesses.

7. We doubt that the capital market bias against risk taking adversely affects the mining and petroleum industries more than other industries. Large mining and petroleum companies can diversify their risks by undertaking many exploration ventures; both large and small companies can form syndicates and pool their risks. Small manufacturing companies usually are unable to spread the risks involved in research and

product development. To the extent that there is a problem, it is a problem mainly for the small mining and petroleum companies which have operating income less than their exploration and development expenses and which do not participate in sufficient joint ventures with other companies to spread the risk sufficiently. However, to remove any possible doubt, some concessionary provisions for exploration and development costs are embodied in our recommendations for the extractive industries.

8. The extractive industries are highly capital intensive and rely on equity financing to a greater extent than many other industries. The argument has been advanced that the adjustment to the imposition of the corporation tax—a tax on the return on equity capital—must therefore be more onerous to the mining and petroleum industries than to other industries; and that more shifting through price changes or larger reductions in investment must be required to restore after-tax rates of return on investment in mineral and petroleum extraction following imposition of the corporation tax. There are, in fact, other industries that rely as heavily or more heavily on equity financing and there are other industries as capital intensive as the mining and petroleum industries. The problem is therefore not unique to these industries. It would not be feasible to reduce the corporation tax for those corporations that shift the tax least—for there are no unequivocal measures of the extent to which the tax is shifted. In any event, the adoption of our integration proposal would remove any tax discrimination against equity financing. This argument is therefore rejected.

9. Tax concessions to the resource industries increase the allocation of labour and capital to these industries and hence to the known reserves and the production of minerals and petroleum. It is alleged that many economic and social benefits result, including increased employment,

domestic investment, exports, industrial development in general and regional development in particular. It is by no means obvious that some of the alleged benefits are, in fact, net benefits. Frequently, it is assumed that the additional employment, investment and output of the mining and petroleum industries are achieved without cost in the form of reduced employment, investment and output elsewhere in the economy.

10. A careful review of the many arguments advanced in support of the present concessions to the mining and petroleum industries does not suggest that the economy would be adversely affected by their removal. Indeed, because of the probable insensitivity of foreign direct investment in the Canadian mining and petroleum industries to changes in after-tax rates of return, the net economic benefit to Canada from such investments could be increased by the withdrawal of the concessions. With the adoption of the proposed treatment of foreign source income of Canadians, substantial increases in foreign direct investment in mining by Canadians are unlikely to occur and such increases, if they did occur, would not necessarily be against the national interest.

11. Canadian mineral and petroleum reserves apparently are not declining relative to rates of utilization. In particular, methods of extracting oil in commercial quantities from the almost inexhaustible Athabasca tar sands have been developed; the costs of discovering conventional crude oil are apparently rising; and the exploitation of the tar sands is being held back because of the limited market for oil. All of these factors suggest that there is no obvious need for special incentives to encourage oil exploration.

12. If, as a matter of public policy, mining and oil exploration is to be encouraged there are several methods of doing so that would be equally effective and much less costly in terms of tax revenue than the present percentage depletion and the three-year new mine allowances.

13. Similarly, if development of the far North is to be encouraged as a matter of public policy, specific incentives for that purpose should be adopted rather than inefficient incentives to particular industries.

EFFICIENCY OF THE PRESENT
MAJOR TAX CONCESSIONS

14. The present incentives to the mining and petroleum industries are relatively inefficient as an encouragement to additional exploration because they increase current after-tax operating income and thus provide only an indirect stimulus to exploration.

15. Percentage depletion is a particularly inefficient incentive because:

a) the more that a company spends on exploration the less its relative benefit from percentage depletion; and

b) percentage depletion appears to have been of little benefit except to the larger companies, which have no need for the incentive to offset any market bias against risk taking.

16. The three-year exemption for new mines is a more efficient incentive than percentage depletion but benefits most the companies that need it least.

17. The rapid write-off of exploration and development costs is the most efficient of the three incentives now available in the mining and petroleum industries.

18. Under the proposed treatment of business income generally, research and product development costs would be written off immediately, inventory costs would be written off against sales or on a loss in value, depreciable assets would be written off at capital cost allowance rates and purchased goodwill either would be amortized over the life of the asset (where the life was fixed) or would be deductible when lost or reduced in value. The application of the same approach

to the costs of mineral and petroleum extraction would therefore call for the following treatment:

a) exploration costs - immediately written off;

b) development costs - deferred and written off against revenue, or written off if the property was abandoned;

c) cost of depreciable assets - amortized through capital cost allowance classes;

d) cost of property rights - amortized on a time or production basis where the useful life or amount of reserves was determinable, or otherwise deducted when a loss in value occurred.

19. It is recommended that exploration costs, including the cost of depreciable assets that could be used only in connection with a specific exploration project, should be included in a separate capital cost allowance class which would be subject to write-off at the rate of 100 per cent.

20. It is recommended that development costs, including the cost of depreciable assets which could only be used for production from a particular mine or oil or gas well, should be included in the same capital cost allowance class with exploration expenses during a transitional period of five to ten years. Thereafter they should be segregated in a separate capital cost allowance class and subject to write-off at a rate of, say, 20 per cent to 30 per cent on a diminishing balance basis.

21. It is recommended that the cost of mining and petroleum properties should be capitalized in a separate capital cost allowance class for each property. The costs should then be amortized by the write-off of amounts related to the operating revenues derived from the same property. The capital cost allowance rate should be substantial, say, up to 50 per cent, in the transitional period, but thereafter

should be set at 10 per cent to 20 per cent of the operating revenue from the property. If the property was disposed of, abandoned or became valueless, the unamortized balance should be written off. During a transitional period of, say, five years an immediate write-off should be allowed for the cost of property rights acquired from a government.

22. Exploration and development expenses which are presently available for deduction but had not been claimed at the effective date of the legislation should be included in the same capital cost allowance class with exploration costs.

23. Losses in the mining and petroleum industries should be available in the same way as other business losses for carry-back two years and forward indefinitely.

24. Consistent with the comprehensive tax base, all profits made on the disposition of mining and petroleum properties should be included in income. Non-residents should be subject to tax on the disposal of Canadian mineral and petroleum properties. The full gain should be included in income, even if some portion of that gain had accrued prior to the effective date. Shareholders would in effect be exempt from tax on the gain accrued to the transition date because of the transitional provision applying to the valuation of shares.

25. It is further recommended that mining and petroleum companies intending to sell shares to finance exploration and development should be entitled to apply for special tax treatment. Under this concession, the purchasers of newly issued shares would be entitled to write down the value of the new shares for tax purposes to the extent that the proceeds of the issue were to be used for exploration and development. This would ensure that the shareholders of such companies would be able to deduct immediately from other income any potential losses from exploration

and development and would reduce the cost of equity capital to mining and petroleum companies undertaking exploration and development projects.

26. Depletion allowances for the mining and petroleum industries should be withdrawn immediately. This includes the percentage depletion for operators, non-operators and shareholders.

27. The three-year tax-exempt period for new mines should be withdrawn. Complete withdrawal should be delayed for five years, but in the interim the amount of tax exemption that could be claimed for any one mine should be limited to $1 million.

28. As an additional transitional measure, taxpayers in the mining and petroleum industries should be permitted to deduct, over three or five years, the excess of formerly non-deductible costs of mining and petroleum properties over depletion claimed.

29. The cost of exploring for minerals outside Canada should be deductible.

30. Payments to the provinces for natural resources should be deductible. Similarly, the mining taxes paid to the provinces should be allowed as a cost of earning income and not as a tax credit.

31. Prospectors and grubstakers should be taxable on their profits. However, any such person who transferred mining properties to a newly formed company in consideration for shares should record the sale at a price equal to his unclaimed costs. He should bring any increment in value into income when the shares became publicly traded if they represented a 25 per cent interest in the company or less.

32. The provisions recommended should apply to all taxpayers, whether individuals or corporations, and should not be limited by reference to the taxpayer's principal business.

33. Adoption of these recommendations would accord more favourable tax treatment to the mining and petroleum industries than to industry generally, particularly with respect to the treatment of costs.

34. These tax concessions to the mining and petroleum industries would more than compensate for any possible capital market bias against risk taking that might, in the absence of the concessions, reduce investment in these industries below the levels required for an efficient allocation of resources.

35. Withdrawal of depletion and the three-year exemption for new mines, coupled with the recommended changes in the treatment of costs described above, would reduce the after-tax cash flow rate of return to integrated petroleum companies and, to a lesser extent, to those mining companies that had operating income after deduction of exploration and development costs. The after-tax cash flow rate of return to non-integrated mining and petroleum companies that had insufficient operating income to offset exploration and development expenses should, however, be improved. The present concessions are greatest for the largest companies, which are the most unlikely to be subject to higher costs of equity capital as a result of a capital market bias. The recommended changes would ensure that the full value of the concessions was available where it was most likely to be needed.

36. Removal of percentage depletion and the three-year exemption for new mines and the full taxation of share gains would be offset to a large extent by the recommended treatment of costs and, for resident shareholders, by the integration of personal and corporation taxes. Nevertheless, a substantial proportion of resident shareholders of mining and petroleum corporations would be worse off than at present. Because most non-resident shareholders of such corporations would not benefit from integration, they would suffer a greater reduction in after-tax income.

REFERENCES

1/ M. Bucovetsky, The Taxation of Mineral Extraction; D.Y. Timbrell, Taxation of the Mining Industry in Canada; C.G. Burton, Tax Treatment of the Oil Industry, studies published by the Commission.

2/ In general, corporations which qualify to use the special tax provisions are those whose principal business activity is in petroleum or mining, although there have been some extensions to corporations in related activities. It is assumed in most of the discussions in this chapter that the corporation concerned does qualify. The implications of limiting the qualification are discussed under the heading "Application of Mining and Petroleum Provisions to Particular Types of Taxpayers".

3/ Section 83A.

4/ Section 83(5).

5/ Regulation 1201(2).

6/ Regulation 1201(3).

7/ Regulation 1203.

8/ Regulation 1202.

9/ Regulations 1300-1303.

10/ For a discussion of the historical justifications for percentage depletion see Appendix K to this Volume.

11/ This survey of large Canadian mining companies was conducted by us in conjunction with the Canadian Metal Mining Association. We shall refer to it hereafter as the Mining Survey. The results are published as an appendix to the study by D.Y. Timbrell cited earlier.

12/ In a recent research study prepared for the Canadian Institute of Chartered Accountants, entitled Accounting Problems in the Oil and Gas Industry, by W.B. Coutts, F.C.A., it was advocated that costs should be accumulated by "area of interest". Such a procedure requires that costs be accumulated for exploration in any particular area while exploration is in process, and that such costs be deferred against production revenue from the area if the project is successful, or be written off immediately if it is unsuccessful. This approach would be supported on a theoretical basis by many practising accountants, but it is beset with practical difficulties. For example, an evaluation of the results of exploring in a particular area could be very much a matter of personal opinion, and management might be inclined to defer a distasteful decision if it meant writing off in one year costs that had accumulated over several years. Furthermore, because an individual project may not be successful, it may be wise to write off arbitrarily a certain percentage of costs while the project is still under way. Thus, while something like the "area of interest" concept would most adequately portray the actual results of operation over a period of time, it is followed in practice by only a relatively few companies. The general procedure is rather to defer costs only in respect of known assets; thus the drilling cost and sometimes the land cost of productive wells may be deferred over their productive lives.

13/ Section 83A.

14/ Regulations, Schedule B, Class 10.

15/ Ibid., Class 12.

16/ Ibid., Classes 1, 3, 4 and 6.

17/ Section 11(1)(a).

18/ Except under section 27(1)(a) which permits, *inter alia*, a deduction of up to 10 per cent of income for gifts to municipalities.

19/ M. Bucovetsky, *The Taxation of Mineral Extraction*.

20/ Because of differences in accounting treatment and because they provide no information about unsuccessful companies, price/earnings ratios are an inadequate measure of relative risk among industries.

21/ A study prepared for the Royal Commission on Banking and Finance by E.K. Cork, *Finance in the Mining Industry*, states at p. 37 that from 1907 to 1953 there were over 400,000 claims recorded in Ontario and 6,679 metal-mining companies formed, of which 348 went into production and only 54 paid dividends. In a supplementary submission to us, the Canadian Petroleum Association cited an average success ratio of 7.4 per cent in exploratory drilling for the period 1947 to 1962, after eliminating from the calculation wells which were initially successful but which later proved unsuccessful.

22/ When investors demand a risk premium, this may reduce the investment in the industry relative to the social optimum because the risk to the individual investor on a particular venture is greater than the risk on all similar ventures taken as a group. Risks can be reduced through pooling.

23/ Because most Canadian corporations in the petroleum industry are subsidiaries of international companies this discussion is less relevant to that industry. There are, however, some Canadian petroleum companies that would be affected.

24/ See the study by Bucovetsky, previously cited, for a comparison of the Canadian and United States provisions.

25/ The indirect costs and benefits are extremely difficult to determine because they depend upon the particular circumstances. See Chapters 5 and 26.

26/ For the period from 1949 to 1962 the amounts paid to provinces for oil rights and rentals amounted to something in excess of $1 billion and, after allowing for deduction of rentals not exceeding $1 per acre and lease costs of abandoned properties (both of which are already deductible under section 83A), possibly $500 million to $750 million would not have been allowed for tax purposes. Various estimates of the amount of such costs were supplied to us by industry representatives, and an amount within this range would appear to be a reasonable estimate.

27/ The amounts of these provincial revenues are indicated by the following figures for Alberta for the sixteen-year period 1947-62 as quoted in Oil and Gas Bulletin of the Royal Bank, No. 17, August 31, 1963:

	(Millions of dollars)
Sale of Crown reserves	653.8
Rental from leases	333.2
Royalties from oil and gas	329.3
	1,316.3

28/ Section 83A(5b).

29/ M. Bucovetsky, The Taxation of Mineral Extraction.

30/ The transitional provision proposed (the allowance of all development costs not already recovered through depletion) would result in a smaller reduction for many companies for a certain number of years.

CHAPTER 24

FINANCIAL INSTITUTIONS

For purposes of this Report any institution that forms a link between those who are savers of money and those who are borrowers of money will be termed a financial institution. The rapid growth that has taken place in the use of credit, and the impracticability of its being provided substantially by direct dealings between borrowers and savers, has led to a considerable increase in the business conducted by financial institutions. Table 24-1 lists the principal financial institutions and, as a rough measure of their size and importance, shows their total assets at the end of 1962.

TABLE 24-1

ASSETS OF PRINCIPAL FINANCIAL INSTITUTIONS, 1962

Institution	Assets (millions of dollars)
Bank of Canada	3,231
Chartered Banks	14,848
Quebec Savings Banks	357
Trust Companies	1,877
Mortgage Loan Companies	1,286
Caisses Populaires and Credit Unions	1,666
Finance and Consumer Loan Companies	2,689
Industrial Development Bank	181
Life Insurance Assets in Canada	9,950
Fire and Casualty Insurance Assets in Canada	1,585
Mutual Funds	710
Pension Funds	4,572
TOTAL	42,952

Source: Royal Commission on Banking and Finance, Report, Ottawa: Queen's Printer, 1964, p. 106.

The Bank of Canada and the Industrial Development Bank, agencies of the Government of Canada, are not discussed in this Report. Credit unions and caisses populaires are discussed in Chapter 20, fire and casualty insurance companies in Chapter 25, and mutual and pension funds in Chapter 16. In this chapter we deal with banks, trust companies, mortgage loan companies, finance and consumer loan companies, and life insurance companies.

BANKS, TRUST COMPANIES, MORTGAGE LOAN COMPANIES, AND FINANCE AND CONSUMER LOAN COMPANIES

All these financial institutions, directly or indirectly, collect the savings of individuals and corporations and lend them. They differ in the forms they utilize to accumulate savings and again in the arrangements by which they lend the funds at their disposal. Some of them concentrate their lending activities primarily in short-term loans, others in long-term mortgages. The types of borrowing which they traditionally use range from demand deposits to long-term debt. The variety is not haphazard or simply a matter of choice, but is closely related to the uses to which each institution expects to put the money in attempting to relate maturities of assets and liabilities. Some of them perform other important services in fiduciary and agency capacities. However, all have the common characteristic of being dealers in financial claims. There has been a noticeable trend toward diversification of activity, with an overlapping of functions, so that many institutions now find themselves competing with others that are essentially known for their activities in other parts of the financial field. Therefore, many of the differences are blurred as the various types of institutions compete with each other on both sides of the borrowing-lending process.

Another general characteristic of these financial institutions is the magnitude of assets under their control in comparison with the equity capital of the companies concerned. This is because they rely so heavily on borrowed funds as an integral part of their method of doing business, a hardly surprising result for institutions that specialize in money. On average, they

derive about 90 per cent of their funds from borrowing, while equity accounts for less than 7 per cent. This may be compared with industrial companies that on average obtain over one half of their total funds from equity sources.

Most types of financial institutions are subject to extensive government supervision and control. Again, this is not surprising in view of the extent to which they are heavily indebted to the public. Questions concerning government regulation are beyond the terms of reference of this Commission. However, we take the position that it is the responsibility of the supervisory authorities and regulatory legislation to see that financial institutions conduct their activities in a way that ensures their solvency; these businesses should not be granted tax concessions to induce them to do so, or to compensate them for doing so.

Main Tax Considerations

Generally speaking, the determination of the income of financial institutions for tax purposes is relatively straightforward. While it is not suggested that the determination of their income presents no problems, the tax problems are, for the most part, common to other industries as well. Furthermore, a number of these problems would disappear with, or be mitigated by, the implementation of certain of our recommendations. For example, under existing tax law, security gains earned as a result of trading activities are taxable, but if derived from investment activities they are not subject to tax. Some financial institutions find themselves in the peculiar position of being taxed on some of those gains but not on others. However, the treatment we recommend for security gains in Chapter 15 would eliminate these discrepancies by subjecting all such gains to tax. As a further example, while interest and general expenses incurred to earn non-taxable dividend income are currently disallowed, the integration of personal and corporation income tax described in Chapter 19 and our recommendations in respect of business income in Chapter 22 would generally result in the allowance of these expenses.

Financial institutions generally account for their revenues and expenses on an accrual basis. Estate, trust and agency fees are exceptions. Estate fees require court approval and are not legally collectible until so approved. It is common practice for trust companies to account for them on a cash basis, and in some cases all estate, trust and agency fee income is accounted for on a cash basis for the sake of internal consistency in dealing with these activities. In addition, some consumer loan companies account for their interest income on a cash basis as permitted by section 6(1)(b) of the Income Tax Act. In line with our general recommendations for the expanded use of the accrual basis, we suggest that it should be required that these forms of income also be recorded on an accrual basis. We believe that acceptable techniques can be readily developed to accomplish this result.

The only problem in the determination of income of financial institutions that is both significant and of particular applicability to them alone arises in the estimation of losses on loans. Loans and other investments provide the major source of income of these institutions and, because of their magnitude relative to equity capital, a small percentage difference in the losses that are incurred on them will have a significant impact on income. For example, a loss of 1 per cent on these investments can be the equivalent of as much as a year's income.

The problem stems from the impossibility of determining accurately in advance what losses will occur on existing accounts. Differences of opinion between the taxpayer and the tax administration as to what is a reasonable provision for losses are not easily reconciled. Apart from the recognized measures of doubtful collectibility such as overdue accounts, management decisions as to provision for losses will be based on other less well-defined, but valid, criteria such as general business conditions, a knowledge of the particular industry, familiarity with the affairs of debtors, and past loss experience.

While the problem of evaluating receivables is faced by all businesses, where the amount invested in them is small relative to total assets their valuation is not likely to bear significantly on the determination of income. In the case of financial institutions, however, materiality and volume combine to make the problem both more significant and more difficult. Financial institutions ordinarily have large numbers of loans and other receivables outstanding 1/. Neither the taxpayer nor the tax assessor can review individually a significant proportion of the accounts within the bounds of reasonable time. Moreover, even if the time were available, it would not be possible in the case of certain secured transactions, for example, those involving mortgages and conditional sale agreements, to complete a useful review of individual accounts, because there will seldom be any data available on the underlying security other than that collected at the time the loan was made.

Present Tax Treatment
of Reserves

The income tax treatment of banks differs in one respect only from that accorded to corporations generally and that is in the treatment of valuation reserves. Banks are permitted to deduct reserves "not in excess of the reasonable requirements of the bank" without having to substantiate them on the basis of losses expected at the end of the fiscal year 2/. In other words, in addition to providing for "specific" or anticipated losses, banks are permitted, within certain limits, to provide reserves for contingencies that cannot be foreseen at the time.

It is the Minister of Finance, not the Minister of National Revenue, who determines the reasonable requirements of banks with respect to contingency reserves. At least once each year the Inspector General of Banks must inquire into the affairs of each bank and report to the Minister of Finance. This examination is made "for the purpose of satisfying himself that the provisions of this Act having reference to the safety of the

creditors and shareholders of the bank are being duly observed and that the bank is in a sound financial condition" 3/. This responsibility includes ensuring that the banks maintain adequate reserves.

At the present time the maximum reserves that a chartered bank can claim for income tax purposes are prescribed in rules issued by the Minister of Finance, which set out the procedure for determining tax-free inner reserves. This maximum is based on a percentage of certain of the assets of banks and in 1963 was 3.504 per cent of eligible assets 4/. This ratio is adjusted annually by a formula that takes into account the change in the average loss experience over successive 25-year periods, and has been declining because of the relatively favourable loss experience of recent years. The Quebec savings banks are permitted reserves up to a fixed percentage of 5 per cent of eligible assets.

The United Kingdom permits banks to make specific provision for bad and doubtful debts, but has never permitted banks to deduct contingency reserves in the determination of taxable income. In the United States, a bank has the option of creating a contingency reserve for loans or of charging annual losses directly against income. Until recently the allowance permitted to each bank for contingencies was based on the bank's own loss experience, the maximum being three times its ratio of annual loss experience to eligible loans for any twenty consecutive years starting not earlier than 1927. However, beginning with the 1965 taxation year, the procedure has been changed to allow a flat 2.4 per cent of outstanding loans. The definition of eligible loans excludes those guaranteed by the federal or state governments or their agencies, but is generally broader than the Canadian definition. It should be noted that this reserve applies to loans only.

The Income Tax Act also permits taxpayers, whose business includes lending money on the security of mortgages, to deduct, in computing taxable income, amounts sufficient to provide up to 3 per cent of their mortgage loans outstanding as a reserve in lieu of the general provisions for doubtful debts otherwise permitted 5/.

The above-mentioned tax provisions are the major ones having specific applicability to financial institutions. It will be appreciated that they go only part of the way in dealing with allowances for losses on the multifarious investments in which financial institutions engage. For loans that are not made by banks or are not in the form of mortgage loans, the taxpayer can invoke the provision that is available to taxpayers generally for valuing receivables 6/. This provision permits a taxpayer to deduct a reasonable reserve for doubtful debts. The most satisfactory method of ascertaining the amount of such a reserve is on the basis of a valuation of specific accounts. Alternative methods are to base the reserve on bad debt experience in recent years and the relative delinquency position (accounts outstanding more than 60 days, 90 days, etc.) of current portfolios of accounts. The valuation of other investments of financial institutions is subject to the same general rules that are applicable to other taxpayers; rules that would become more certain with the inclusion of all gains and losses in the computation of income.

The statutory provision in the United Kingdom is somewhat more stringent than in Canada, and the tax authorities do not accept allowances calculated as a percentage of total receivables. However, as in Canada, they will accept allowances calculated with reference to total amounts delinquent for various periods of time. The statutory position in the United States is more flexible and we understand that allowances are permitted there that are somewhat more favourable than those allowed in Canada but, nevertheless, protracted negotiation is often required.

Evaluation of Present Tax
Treatment of Reserves

Before commenting on the present tax treatment of financial institutions, it will be useful to make a brief reference to certain general conclusions that we reached earlier in the Report.

First, the importance of tax neutrality has been emphasized. Although

different financial institutions bear different designations and are governed under different statutes, their functions overlap and they are competing with one another increasingly. In these circumstances, it would be inequitable to apply different tax rules to different institutions, except where necessary for administrative reasons, and even then material differences in tax impact should be avoided.

Secondly, general or contingency reserves should not be recognized for tax purposes. Only those losses in asset values and those liabilities that can reasonably be expected to occur should be allowed. All business is subject to some risk and uncertainty in the ascertainment of income on an annual basis. We believe that the general recommendations we make for the treatment of annual losses would provide sufficient recognition of these factors for taxation purposes.

Thirdly, where it is extremely difficult to determine reasonable annual allowances, we have acknowledged that it may be necessary to adopt rather arbitrary procedures. For example, we conclude in Chapter 22 that the use of simple, and arbitrary rules would be appropriate in the case of depreciation provisions, because of the high degree of uncertainty in matching this kind of cost against revenues 7/.

Finally, we have said that where certain actions are deemed to be necessary or desirable as a matter of public policy, taxation should not be the vehicle for regulating the actions where other more direct measures are available.

Allowances for Doubtful Accounts. The valuation of receivables under the existing general tax provision presents difficult assessment problems. Even though the tax authorities are willing to accept arbitrary procedures for determining the allowance for doubtful accounts which might result in an amount liberal to the taxpayer, there continue to be many disputes as to the reasonableness of the loss allowances that are claimed 8/.

We recommend in Chapter 22 the withdrawal of the existing general provision in respect of doubtful debts, on the grounds that it appears to rely primarily upon what is "reasonable", that the test of reasonableness should be found in the application of accepted accounting and business practice, and that the provision is therefore unnecessary. Where amounts claimed appear to be reasonable and are not significant determinants of income, there would seem to be little call for disturbing them on assessment.

It must be conceded, however, that repeal of the provision would not solve the basic problem. Where an allowance for losses is a significant determinant of income, and where objective evaluation of specific accounts is not possible, allowances that are claimed by taxpayers cannot be accepted for assessment purposes without careful review. Inasmuch as we recommend that all business costs be allowed, including accounts that ultimately proved to be uncollectible, the application of arbitrary rates of provision against such accounts to determine the amount of an allowance may be appropriate where the problem was significant and undue difficulties of compliance and administration could be mitigated. In the interests of administrative simplicity and consistency, these arbitrary rates might be applied in all cases if practical means could be found for doing so. The alternative to arbitrary rates would be the application of criteria which would be more contentious and more difficult to administer, but which would still not reflect accurately in advance what losses were likely to arise, and therefore might well be inferior to well-chosen arbitrary rates.

It is apparent that to be administratively most effective, optional arbitrary allowances would have to be based on rates that were sufficiently generous to ensure that most taxpayers would elect to use them rather than make detailed estimates. If the taxpayer was not allowed the option of either using the arbitrary rates or making detailed estimates, the arbitrary rates would still have to be sufficiently generous to ensure that few, if any, taxpayers suffered because of the requirement. Nevertheless, rates should not consciously provide a margin for contingencies.

Trade accounts receivable will ordinarily result from a sale that has been reflected in income. The most accurate matching of revenues and expenses in terms of timing would call for accounts that proved to be uncollectible to be matched against the revenue recorded at the time of sale, rather than at the time the account was determined to be uncollectible. Because this would usually involve reopening the accounts of a past year whenever an uncollectible account was written off, practical considerations call for making allowances in the year of sale on an estimated basis to the exclusion of making any retroactive adjustment on the basis of subsequent events. Indeed, it is the necessity of having a practical basis for matching revenues and expenses that constitutes the justification for doubtful account provisions in general and, in the case of financial institutions in particular, for permitting allowances for losses in advance of the determination that a debt is uncollectible. There is, however, one important respect in which the opening of a loan account receivable differs from an ordinary trade account. The loan is not always a reflection of income that has already been taken into account, but is usually evidence of an investment, the income from which will accrue subsequently. We do not suggest that this distinction is of much assistance in determining the loss provisions that should be allowed to financial institutions 9/. However, it should be appreciated that to make full allowance against losses as loans were granted would not necessarily represent a more accurate matching of revenues and expenses than would the claiming of the expenses only as accounts proved to be uncollectible.

The problem of estimating the ultimate collectibility of a long-term real estate mortgage will ordinarily be greater than in the case of a short-term loan or of a trade account receivable. It does not follow, however, that the allowance for loss should be higher. The type of security held is of basic relevance, and a real estate mortgage ordinarily has greater protection against loss than an unsecured trade account receivable.

It also should be emphasized that no allowance should be made for an untoward economic trend that cannot be foreseen. Such a provision would be carrying the principle of providing for losses beyond what appears to be reasonable, that is, beyond losses and into the area of possible losses. Moreover, commercial businesses are subject to this risk, many of them to a much greater degree than financial institutions, and it is difficult to contemplate how such a provision could be applied generally in a reasonable fashion. This general economic risk is just one of the risks of being in business that should not, and cannot, be the basis of a tax allowance.

The matter of reserves for financial institutions was reviewed by the Royal Commission on Banking and Finance and that Commission recommended the continuation of an allowance at a level somewhat higher than the allowance now granted to the chartered banks. The emphasis of our consideration has been primarily on the tax implications of the present treatment, and we have made it amply clear that we are averse to the use of the tax system for objectives other than those we have referred to frequently in this Report. We have expressed our understanding of the need for reserves against possible losses on loans and investments within the dictates of ordinary commercial and accounting practice, and for administrative reasons we see considerable advantage in the use of an established rate. However, we find ourselves unable to accept the view that an allowance larger than is justified on these grounds should be granted in order to assist in preserving the liquidity and soundness of a financial institution. We are much more inclined to agree with the Banking Commission in its general approach that the public benefit will best be served by institutions whose strength rests to some extent on public inspection and supervision, but primarily is based on the ability of the institutions to meet competition in a financial market which has been freed of some of the artificial impediments which now exist in Canada.

We stated earlier that taxpayers should not be permitted to claim general or contingency reserves for tax purposes, but rather that they should be

restricted to making a reasonable provision for expected losses. If certain institutions need to be regulated to ensure their continued solvency and liquidity, we do not believe that such regulation calls for any departure from the general rules for determining their actual income for tax purposes. Indeed, we do not believe that tax legislation should be designed to assist in ensuring solvency and liquidity. Such policy goals can be provided for adequately only by specific legislation, and there is legislation in force that specifically provides for the regulation of such institutions. However, we have pointed out that it can be extremely difficult to value a large number of receivables in a manner that is acceptable both to the taxation authorities and to the taxpayer. For the same reason that arbitrary depreciation allowances have proved to be a relatively efficient and mutually satisfactory way of allocating costs for tax purposes, so have the arbitrary reserves for banks and mortgage lenders proved to be attractive from the administrative point of view. It should be noted, however, that an arbitrary allowance provided for a type of institution, rather than for a type of loan, has the weakness of allowing the same loss provision against relatively secure loans (other than those that may be specifically excluded from any loss provisions) as against relatively high risk loans, and is unfair as between competing types of institutions.

In the case of banks and on the basis of long-term loss experience, the permitted ratio of valuation reserves to eligible assets appears to exceed greatly the rate that would be employed to reflect an allowance for bad debt losses only. While an allowance based on previous loss experience could be unrealistic, we believe that past experience is the best single criterion on which to establish an arbitrary rate of provision against bad debts. Although during one five-year period in the 1930's losses averaged 1.25 per cent of loans, over the twenty-five-year period from 1940 to 1964 the annual average loss experience was about one seventh of 1 per cent 10/. While the annual loss experience is only one factor in determining a reasonable loss allowance, a reserve exceeding twenty times the average loss experience over the last twenty-five years would appear to be excessive.

Unfortunately there is no meaningful breakdown of the present inner reserve figures into their two components, specific and contingency reserves, the former reflecting expected losses, and the latter possible losses. The Royal Commission on Banking and Finance pointed out that specific reserves were about three quarters of 1 per cent of eligible assets, 11/ but since at present little significance is attached to the division between specific and contingency reserves, this percentage is unlikely to represent what the specific reserves would be if computed carefully.

One other percentage that is of interest because it reflects the position of a competing institution that specializes in higher risk loans, is the allowance for doubtful accounts established by those companies in the small loan business. At the end of 1963, their allowance for doubtful loans was 2 per cent of outstanding accounts 12/.

Another consideration is whether one arbitrary rate should apply to all loans, or whether there should be a number of rates to reflect the varying loss experience on different kinds of loans. Certainly a single average rate would tend to be relatively less favourable for the bank that accepted a greater degree of risk. Although it would obviously be difficult to define the kinds of loans in a manner that would segregate them into risk classes, the present arbitrary allowance is already selective to some extent, because it applies only to certain assets. However, some of the assets included would virtually never be realized at a loss, while other assets involve a certain amount of risk. In addition, it would be expected that on average the losses would be relatively higher for the smaller loans than for the larger ones.

A final consideration relates to the administrative problem of determining the loss provisions for a large number of accounts. Because the taxpayer should always be given the option of claiming specific reserves if he found the arbitrary allowance to be deficient, it is desirable that there should be a liberal arbitrary allowance applicable to those accounts where the determination of specific allowances would be unreasonably time consuming.

Because over 99 per cent in number and 50 per cent in amount of the bank loans outstanding are under $100,000, 13/ the need for arbitrary provisions is greatest for these accounts.

As in the case of allowances for loan losses of banks, some arbitrary rule for determining allowances for losses on real property mortgage loans could produce administrative simplicity and taxpayer equity, while providing a degree of certainty. The present provision for real property mortgages appears to do these things, while having the additional desirable feature of relating the allowance to a type of asset, rather than restricting it to a kind of business. However, in line with our other recommendations that reduce the importance of the distinction between operating a business and holding an investment, it would appear more reasonable to extend this allowance to all taxpayers rather than only to those who are in the business of lending on this type of security. In addition, a review of the actual mortgage loss experience over the past thirty years leads to the conclusion that the present arbitrary rate of 3 per cent on these relatively secure investments is excessive 14/.

We question also whether a single arbitrary rate should apply to all mortgages. Obviously the degree of risk is not uniform as between, say, first and third mortgages. There already exists a generally acknowledged test for distinguishing between secure and hazardous loans in the laws which prohibit federally or provincially incorporated trust and loan companies from acquiring mortgages with a face value exceeding 75 per cent of the fair market value of the real property. Although there are no accepted standards of valuation that would ensure that this rule is applied uniformly across the country, it is important that the group of companies under federal and provincial trust, loan and insurance legislation, which hold the major proportion of the outstanding real property mortgages, are limited to loans of up to 75 per cent of the fair market value of the security. Therefore, to distinguish between mortgages on the basis of whether they were more or less

than 75 per cent of the value of the property is an arbitrary distinction that could be readily applied, because most of the companies concerned would only qualify for a single arbitrary reserve rate. It thus would be practical to have two rates for determining allowances, one for mortgages (whether first, second or third) that in total did not exceed 75 per cent of the value of the property and a second, and higher rate for other mortgages. There obviously would be administrative difficulties for those companies with a mixed portfolio of mortgages that qualified for both rates, but we do not think these problems would be insoluble, and we feel that the advantages of arbitrary rates would outweigh the problems involved, particularly because most of the problems would be of a transitional nature in establishing the procedures to be followed. The legislation should probably specify that all companies regulated by specific federal or provincial legislation (relating to trust and loan companies and insurance companies) would be eligible only for the low rate, while all other taxpayers could split their portfolios into the two classes of mortgages.

The present tax legislation does not contain any arbitrary allowances for doubtful accounts other than those already mentioned. However, the problems of compliance and assessment that we have discussed in connection with banks and mortgage lenders are also encountered by other financial institutions. This is true of those institutions that have a large number of accounts making up a substantial proportion of their assets and who experience some difficulty in determining an appropriate reserve on an account-by-account basis, or even in negotiating some arbitrary rates that are acceptable to the Department of National Revenue. We have stressed the importance of neutrality of treatment of competing organizations, but have also stated that arbitrary rates should be applied only in cases where it was not administratively practical to do otherwise. The two arbitrary provisions discussed above are readily applied because there is little difficulty in determining what qualifies as a bank, or what qualifies as a real property mortgage. While some of the other financial institutions are

as easily defined because they also are incorporated under special legislation, the allowance of arbitrary provisions to trust companies, credit unions, and small loan companies, for example, would to some extent increase the competitive inequities unless such provisions were also extended to finance and other companies of a similar nature. Unfortunately, the latter companies cannot be so easily defined. If it should be decided that an extension of the arbitrary provisions was warranted, the preferable method would appear to be an expansion of the allowance for mortgages. For example, if the mortgage provision were expanded to include mortgages and conditional sales agreements on chattels, most of the loans of financial institutions would become eligible for arbitrary provisions. There would be some difficulty in administering such an extension, because it would encourage some taxpayers to rearrange their loans so as to qualify, but at least such an approach would not extend a preference to only some kinds of businesses.

Deduction of Bad Debts. Ranking equally in importance with the control of provisions for doubtful accounts, is the exercise of control over the circumstances under which bad debts may be written off against income for tax purposes or against accumulated provisions for doubtful accounts. Rules respecting provisions for doubtful accounts are of little consequence, particularly in the case of arbitrary provisions, if debts may be written off by the taxpayer at will 15/. We believe that this control is best established for taxpayers who claim the arbitrary reserves by limiting the write-off of bad debts to accounts in respect of which it can be proved that a "loss" has occurred. The term "loss" would continue to have the meaning ascribed to it in current jurisprudence 16/.

Appraisal

Our basic conclusion is that there is little reason not to tax financial institutions in the same way as other taxpayers. Therefore, not only should all our general recommendations apply equally to these institutions but, in particular, the treatment of their reserves should be altered to conform to

general practice. The allowances for expected losses should be computed on the basis of accounting and business principles. No contingency element should be included. The term "reserve" should no longer be used in this context; the word "provision" or "allowance" or some similar term is a more appropriate designation.

Because the application of accounting and business principles in this area cannot always be easily and equitably administered, we conclude that financial institutions are a reasonable subject for the greater use of arbitrary allowances. Nevertheless, the use of such arbitrary allowances should not become a means of claiming contingency reserves. Although it would be desirable to make arbitrary rates and their attendant advantages available to other taxpayers concerned with the valuation of receivables, the difficulty of determining percentages that would be a reasonable reflection of expected losses for the full range of business receivables seems insurmountable.

Banks. In the case of banks, it would appear that the best way to give effect to our conclusions would be to vary the arbitrary rates by the size of the loans outstanding, and to further restrict the assets that would be eligible for such allowances. Specifically, we recommend that banks should continue to be allowed to employ an arbitrary provision for certain kinds of loans; that the list of eligible loans should be further limited so as to remove loans to municipalities and school boards, call loans, guarantees and acceptances, letters of credit, foreign exchange provisions, and any publicly traded securities not already excluded; that the allowable provision should vary in relation to the size of the loan balance outstanding; that there should be two arbitrary procedures which are optionally available; and that the overall level of the permitted reserves for tax purposes should be substantially reduced. Each bank would then be able to elect one of three general methods of determining its loss allowance for loans, depending upon which of the following procedures appeared most appropriate in the circumstances:

1. A specific reserve arrived at by valuing each loan.

2. An arbitrary allowance based on the outstanding balances of eligible loans. Rates of something less than 2 per cent for balances of up to $100,000, and of one half of 1 per cent for balances of between $100,000 and $500,000 would appear to be reasonable. The suggestion of something less than 2 per cent is based largely upon the experience of small loan companies which would probably have higher losses than banks and have found that a provision of 2 per cent is adequate. This allowance would also be based on the expectation that on average the larger loans would show an even lower loss experience. The percentages chosen should represent an average of what would be reasonable for the smaller loans and the larger balances.

3. An arbitrary allowance for eligible loans that were under the defined limit of $500,000 of up to seven times the average loss experience for the previous five years. The loss experience for each of those years would be defined as the net write-offs for the year expressed as a percentage of the eligible loans outstanding at the end of the year. Because different banks specialize in different kinds of loans, some probably experience more losses than others. A single arbitrary rate for all loans of the same general size might tend to discourage entry into less secure loans, and therefore we suggest this alternative to take such loss experience into consideration.

Loans in excess of $500,000, although numerous, should nevertheless not greatly exceed 2,000 in number for any one bank. These larger loans can reasonably be reviewed individually in the regular manner applicable to other taxpayers (which might well include the development of arbitrary procedures based upon past experience) to establish a reasonable provision for expected losses in the near term.

Federal and provincial securities with maturities in excess of one year from the date of issue which are held by financial institutions should

be valued on an amortized basis rather than at the lower of cost or market. This method of valuation is preferable for these companies because the securities are usually held for longer periods as an investment. Accordingly it provides a better matching of revenue and expenses than a valuation at the lower of cost or market. However, in order to provide for the substantial losses that may occur on disposal of the securities, it would appear reasonable to allow these institutions an arbitrary allowance of one half of 1 per cent of the amortized value.

We can see no justification for allowing a provision for tax purposes that was greatly in excess of that required to provide for reasonably expected losses. Therefore, the arbitrary rates to be employed should reflect the expected losses, and should bear a reasonable relationship to the provisions claimed by competing institutions. The actual rates to be employed should be designated only after more detailed analytical work had been completed on the actual loss experience of the various financial institutions.

We do not believe that the deductible allowances should be in any way related to what the banks record in their fiscal accounts.

Because these proposals involve a substantial adjustment in the existing tax allowances, special transitional provisions in the Act would be required. Therefore, a period of not more than ten years should be allowed for the gradual adjustment of the present tax allowances to the proposed amounts. It should be emphasized that the banks would not have to maintain their accounts on the same basis as the proposed tax allowance, and would be permitted to claim specific allowances if they did not elect to use the arbitrary percentages.

The savings banks should be subject to the same arbitrary provisions as other banks.

Mortgages. Section 85G which contains the loss provisions for real property mortgages should be amended to apply to all taxpayers (except banks) whether or not they are in the mortgage business, to exclude all insured mortgages (not only National Housing Act mortgages), and to differentiate in general between mortgages that are for less than 75 per cent of the fair market value of the real property and those that are for amounts exceeding this limit. The present allowance of 3 per cent should be substantially reduced to something close to 1 per cent for those better secured mortgages under the 75 per cent limit, and to something less than 2 per cent for the other mortgages on real property. A size limitation of $500,000 should also apply, because a very large mortgage should be capable of periodic review and assessment.

This arbitrary provision should not apply to any insured mortgage loans, including National Housing Act loans, because the risk of loss has been transferred, in whole or in part, to the insuring organization. The insuring organization should be permitted to base its allowance for tax purposes on these same arbitrary rates. In addition, the banks should be excluded from the application of this provision, not only because of certain arbitrary allowances already proposed for the banks, but because of the difficulty of differentiating between ordinary loans and loans secured by mortgages. However, the proposed arbitrary rates should generally be such that mortgage companies and banks would be claiming similar allowances.

The present limitation on the annual increase in the allowance for mortgage losses contained in Section 85G does not appear to be consistent with the concept of providing for expected losses, and therefore should be removed.

Taxpayers should be able to elect to set up their loss allowances on the basis of an appraisal of individual loans. There should be no requirement that the tax allowance and the books of account be in agreement. Again, it would be necessary to provide for the gradual adjustment of the present tax allowances to the proposed amounts. However, the adjustments would be

relatively smaller in this case, 17/ and a period of five years would appear to be reasonable.

While, in general we have concluded that loans and mortgages on which arbitrary allowances have been claimed should be written off (for tax purposes) only when an actual loss has taken place, we appreciate that such a procedure can also be administratively difficult. Therefore, we recommend that the write-offs for banks should be accepted without dispute so long as the recoveries did not exceed 10 per cent of write-offs. Any recoveries exceeding the designated percentage should be carried back to the earliest years of write-off for the accounts recovered, tax should be assessed on such increment in income, and interest charged for the number of years involved. Alternatively, it could be provided that in the case of small balances of under $10,000, a bad account would be eligible for write-off if no payment on account had been received for two years.

Other Financial Institutions and Other Accounts. We considered the extension of arbitrary allowances to other financial institutions as well as banks and to other accounts receivable as well as mortgages. In some cases, the use of general accounting and business practices could be just as inequitable and administratively complex for other taxpayers as for banks and for other accounts as for mortgages. Therefore such an extension might seem warranted. If this were to be done, the preferable method would appear to be an expansion of the mortgage allowance to include chattel mortgages and conditional sales agreements. The percentage used should be the same as the highest rate applicable to real property mortgages, which in turn should be equal to the arbitrary rate allowed to banks for the smaller accounts. This would ensure that only a minimum of account analysis would be necessary, and that most of the competing businesses would be on the same basis regardless of the form in which the loans were made. However, for various reasons we are unable to recommend the immediate implementation of such a measure, which would be significant for credit unions and caisses populaires, small loan

companies, and finance companies. For one thing, arbitrary rates should be sanctioned only when required as a matter of administrative convenience, as we explained earlier. Also, the use of flat rates, regardless of risk of loss, would give a greater benefit to some taxpayers than to others 18/. Finally, we cannot be sure that there would be a sufficient reduction in administrative complexity and improvement in taxpayer equity to warrant the revenue cost that could result.

Although the adjustments to the reserves of banks and mortgage lenders that we recommend are substantial, the liberal transitional provisions would spread out the tax impact over a number of years. In addition, since we recommend that the mortgage allowance be granted to all taxpayers, we would not expect the increase in tax revenues to be large.

LIFE INSURANCE COMPANIES

Characteristics of These Companies

The principal business of life insurance companies is entering into contracts to provide life insurance and life annuities. Some companies also write personal accident and sickness insurance.

The importance of the life insurance business is indicated by the fact that the total assets employed by Canadian life insurance companies in Canada and elsewhere at the end of 1964 amounted to over $11 billion, primarily in mortgage loans and bonds. The net investment earnings for that year from assets in Canada amounted to approximately $410 million for Canadian companies, and approximately $140 million for non-resident companies.

Life insurance exists because of the desire of individuals to provide for their financial responsibilities upon death. Because of the unpredictability of the time of this event for any one individual, and the problem of ensuring that he will have accumulated sufficient assets before that time to meet these requirements, the practical way to provide protection against

"mortality risk" is to share it with others so that its cost becomes predictable. There is a problem involved in this sharing, because the mortality risk, and therefore the cost of insurance, increases with age. This has been solved by the introduction of the level premium method under which premiums are greater in relation to the mortality risk in earlier years, and less in later years. The excess portion of the premiums in early years enables funds to be built up, the income from which reduces the cost of the insurance to the policyholder 19/.

Saving Aspects. The level premium method creates a form of saving. The individual could, instead of purchasing level premium life insurance, even out his total insurance costs by purchasing term insurance on a year-to-year basis. The funds which he would otherwise pay for a premium in excess of the mortality risk would be used to buy investments which, with the accumulated income thereon, would offset the higher cost of term insurance at a later date.

In addition, many insurance policies are available with various saving elements in addition to the provision for mortality risk. Most policies other than pure term insurance have a cash surrender value which ensures some return of amounts paid in premiums in the event of surrender before death occurs. Endowment policies provide for payment of a lump sum amount provided the policyholder survives to a specified age. Endowment policies may also have options under which the policyholder can convert the lump sum into an annuity and in this way provide for additional income upon retirement.

Role of the Insurer. Although the insurance business may be considered in a very broad way as pooling of mortality risk and saving, its wide-scale operation depends upon the introduction of an important intermediary, the insurer. This organization, which is a separate legal entity, contracts to provide a given amount of protection in the future for a given cost, 20/ subject to certain participating elements which will be referred to later.

The business of the life insurer is unique in certain respects when compared with other types of business. In most businesses the capital is primarily provided by the shareholders or investors who bear no relationship to the customers of the business. Commitments to customers are usually short term, and even when they are long term, as for example, in guaranteeing products sold to customers, they are not the dominant feature of the business. The general situation in life insurance is quite different. As an insurer grows in size, its principal customers—the policyholders—become the main source of funds, with the participating surplus and the actuarial reserves representing the policyholder's substantial interest in it. The important feature of the business is that the insurer commits himself contractually to meeting certain obligations to these customers over very long periods of time.

The main problems of income determination for the insurer are therefore in estimating the amount of the liability for future payments which will arise out of commitments already made, and in estimating its future investment income and expenses. In setting the premiums which it charges to the policyholders, assumptions must be made regarding future "experience" in respect of the three main elements, mortality, investment income, and expenses. The provision for the liability in respect of business which has been written is commonly referred to as a "policy reserve" or "actuarial reserve", but might more accurately be described as a "provision for future policy claims". In estimating this provision, the amount of policy benefits that are expected to be paid in future years based on established mortality tables, and the premiums yet to be received, are discounted to the present year by the application of a rate of expected investment yield. Thus, the current policy reserve, future premiums, and the investment income on such funds should accumulate to an amount sufficient to meet the expected claims. Expenses are usually covered by a "loading charge" included in the premiums.

Because of the uncertainty of long-term projections, the assumptions made regarding investment earnings and mortality and expense experience

tend to be conservative, and surpluses are often created as the actual results prove more favourable than those anticipated in setting the premiums.

Investment Policy. Commitments being of fixed amounts, insurance companies invest primarily in securities which involve little risk to capital, yield a fixed return and are of a long-term nature. In 1964 the market value of common shares in Canadian and foreign corporations represented about 8 per cent, and the book value about 4 per cent, of the assets held by all federally registered life insurance companies, although by legislation they were each permitted to hold up to 15 per cent in such shares. In 1965, this limit was extended to 25 per cent.

Participating and Non-Participating Insurance. In participating insurance, which represents about 70 per cent of the insurance in force today, the pooling aspect of insurance is emphasized, and the fixed commitments of the insurance company modified. The premiums for participating insurance are as much as 20 per cent to 30 per cent higher than for non-participating insurance, but the policyholder is given the opportunity of sharing in the favourable experience of the insurance company and presumably he hopes that such participation, in the form of policy dividends, will result in a net insurance cost lower than that for a non-participating policy. Competition between insurance companies provides some assurance to the policyholder that policy dividends will be forthcoming. However, the participating policyholder has no contractual right to share in favourable results, and there is no guarantee that policy dividends will be paid. Under non-participating insurance the commitment of the insurance company is fixed, and competition tends to produce premiums that do not vary widely from company to company.

Stock and Mutual Life Insurance Companies. The distinction between stock and mutual life insurance companies is not as clear as the distinction between ordinary corporations and co-operatives. The stock life insurance company may do a considerable amount of participating insurance business, and in respect of this business is in effect operating a co-operative enterprise.

In the accounts of a life insurance company the participating and non-participating operations are clearly segregated. As far as possible the segregation is applied to premiums, claims, actuarial provisions, salesmen's commissions, etc. For investment income, however, an arbitrary method of apportionment has to be adopted, because the assets are not split into separate funds. While the method of apportionment varies among companies, it is usually based on the average amount of assets in the two lines of business for the year. The method of allocation is closely supervised by the Department of Insurance to safeguard the interests of the participating policyholders.

In a stock company the shareholders are limited in the extent to which they can share in the surplus arising from the participating business. They are entitled to a maximum of 2.5 per cent to 10 per cent (depending on the size of the participating fund) of the amount of participating dividends that are distributed from the surplus earnings of the participating business. All the surplus arising from the non-participating business is for the account of the shareholders. However, no income tax is paid on either of these surpluses until such time as they are formally allocated to the credit of the shareholders. In practice, only sufficient surplus is allocated to cover dividend requirements and to provide a small margin. Thus, basically the stock companies pay income taxes only on dividends paid.

In a mutual life insurance company the ultimate owners of the company are the participating policyholders. Accordingly, they are entitled to surplus earnings created from all the business, non-participating as well as participating. However, because there are no shareholders, there is no income for tax purposes and no income tax is paid. Since 1958, five large Canadian life insurance companies have "mutualized", a procedure under which the policyholders in effect buy out the shareholders. The primary reason for this change was to keep control of the companies in Canada, and it was financially possible because of the magnitude of policyholders' capital in an insurance company. By special statutory provisions the amounts paid for the shares were entirely tax free to the recipients.

International Aspects. The international aspects of the life insurance business are important because about 30 per cent of the life insurance in force in Canada is placed with non-resident companies, and about 30 per cent of the insurance carried by Canadian companies is on non-residents, most of whom live in the United States.

Public Interest. The provision of funds to indemnify the estate of an individual, his dependants, or both, in the event of death has long been considered important from a social standpoint. Practices of the industry are supervised by the Department of Insurance, and no policyholder in a regulated Canadian life insurance company has ever lost a dollar through non-payment of the amount guaranteed under his policy. Under federal legislation governing the insurance industry, the investment yield assumptions in setting actuarial reserves cannot exceed 3.5 per cent for insurance, or 4 per cent for annuities. Recently, however, this has been modified to permit higher interest assumptions if special permission is given by the Department of Insurance.

Main Tax Considerations

Life Insurance as a Business. Life insurance has grown into a highly complex business employing large amounts of capital. In a society in which business income is taxed either to a corporate entity or to an individual, it is appropriate that the business income of a life insurance corporation should be taxed in a manner similar to the income of other businesses, after taking into account its special features. That surplus earnings do emerge beyond those needed for the protection of policyholders was clearly shown in the prices paid to shareholders upon mutualization of certain Canadian companies in recent years 21/.

Measurement of Income. Ignoring for the moment the problems presented by participating insurance, the major difficulty in measuring the income of a life insurance business results from the long-term nature of its commitments. Because of this it is contended by some that an annual measurement

is futile and that any surpluses indicated in an annual measurement are needed to provide for unforeseen contingencies which may produce unfavourable experience in the future. When viewed in relation to other businesses, however, this contention is not convincing. The problems of annual measurement are not unique to the life insurance industry. There are other kinds of businesses in which the income may not finally be established for many years. For example, in the oil and forestry industries it is not unusual for capital to be committed for periods of 50 years, from which the final income to be derived cannot be forecast with any degree of accuracy.

The fact that the long-term nature of the life insurance business lies in its commitment to customers in the future is unique, but this does not mean that for tax purposes future contingencies should be provided for as the management sees fit. In the same way that there must be a limit on the rates at which depreciable assets can be written off, provisions for future liabilities should be subject to reasonable limitations.

The degree of latitude in providing for future liabilities of the life insurance business should be governed by the degree of uncertainty involved. This uncertainty centres primarily upon the possible future changes in mortality, expenses, and investment yield. With respect to mortality, the use of any of the accepted tables appears to be conservative, and accordingly, the only major mortality hazard would appear to lie in events such as war or epidemics. Except in case of violent inflation, the expense variations do not seem to be serious. Fluctuations in investment income are certainly an important element, but through its investment policy an insurance company can level out short-run fluctuations to a considerable degree. Most investments are of a long-term nature with a fixed return, some of which are uncallable, and most of those callable are subject to a premium. The investment yield assumptions used in calculating the policy reserves are usually quite conservative. At the present time, we understand that the typical assumption would be 3 per cent to 3.5 per cent, 22/ and yet the average net

yields for the insurance industry have not fallen below 3.5 per cent since 1900, and were almost 5.5 per cent in 1964. Since 1931, when the average annual yield fell below 6 per cent, there was only the seven-year period of 1945 to 1951 when the average annual yield was under 4 per cent, and it has increased every year but one from the 1948 low of 3.57 per cent. (See Chart 24-1.)

Furthermore, any adequate system of taxing income from life insurance must recognize that income may arise from favourable mortality and expense experience, as well as from an investment yield in excess of that required to meet obligations.

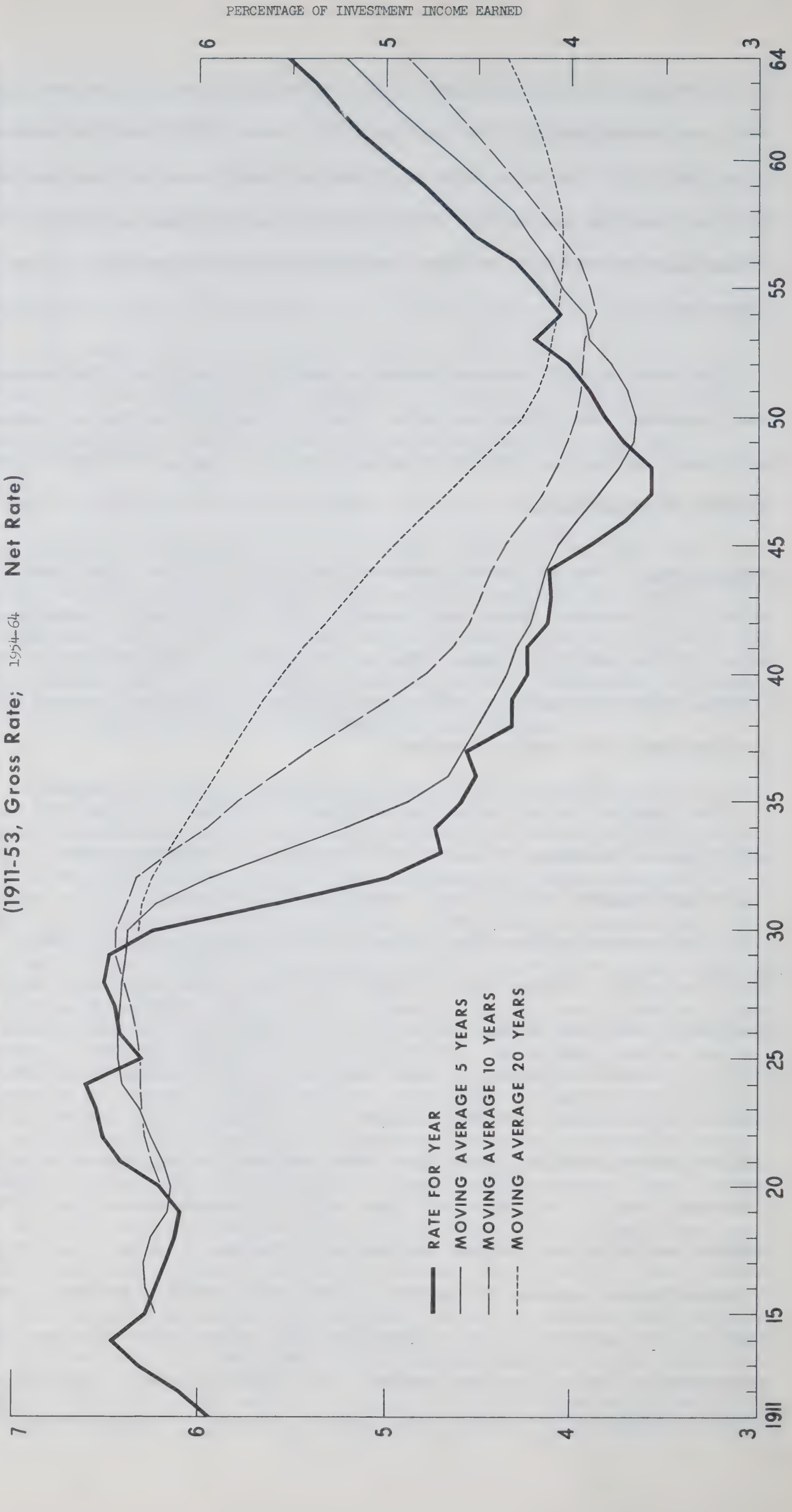
Mutual Aspect. Participating insurance, written by either joint stock or mutual life insurance companies, presents further problems in measuring the amount of the business income. The tax treatment is best explored by considering first the basis on which participating premiums are charged and the components of a policy dividend.

The premium for participating insurance is higher than that for non-participating insurance to allow for experience in investment yield, mortality and expenses that is less favourable than can reasonably be expected (and less favourable than that assumed for non-participating insurance). Thus, the policy dividend may be viewed as arising from experience more favourable than that assumed in setting the premium for the participating policy. It has been argued by some that the policy dividend therefore merely reduces the insurance coverage to cost. To the extent that the policy dividend represents results better than those assumed for non-participating insurance, that is, to the extent that policy dividends exceed the difference between participating premiums and non-participating premiums, this argument is unacceptable, because the ensuing income would normally accrue to the owner of the business. To the extent that the policy dividend arises from experience no better than that assumed for non-participating insurance, the policy dividend could be said to be merely a return of "excess premium" which

Chart 24-1

AVERAGE RATE OF INVESTMENT INCOME EARNED BY CANADIAN LIFE INSURANCE COMPANIES

(1911-53, Gross Rate; 1954-64 Net Rate)



would not be required from a policyholder such as a non-participating policyholder who had no participation in the income of the company. On the other hand, the participating policyholder has no contractual right entitling him to any dividend.

However, in our discussion of the taxation of payments received from life insurance in Chapter 16, and in our discussion of co-operatives and other forms of mutual enterprise in Chapter 20, we emphasize that the only consistent and reasonable way to tax distributions by the organization to the shareholder, member, or policyholder is to regard such a distribution as a distribution of income and therefore to tax it in full in the hands of the recipient. We reached this conclusion largely because of the administrative problems of determining what proportion of the distribution, if any, is a return of capital, that is, the "excess premium" paid. The policy dividend therefore should be deductible to the company and taxable to the policyholder in somewhat the same manner as business income earned in a co-operative and distributed to its members 23/. However, to the extent that dividends are paid out of surplus existing at the effective date of the legislation, they should not be taxable to the policyholders and therefore should not be deductible to the company. The rules for determining what dividends would be considered to have been paid out of this surplus should be consistent with the rules relating to corporate distributions and would be worked out in co-operation with the insurance industry. We recommend that a 15 per cent withholding tax should be deducted by the company from taxable dividends paid or credited to policyholders. As is the case with co-operative enterprise generally, it is possible to "price out" participating insurance by lowering the original premium, although this possibility would be limited by the need for financial stability.

Investment Conduit Aspect. The main tax considerations we have discussed so far have dealt with the surplus earnings created in a life insurance business. The surplus earnings arise when the experience in respect of investment yield, mortality, and expenses is found to be better than that

required to meet the liabilities of the business. It must not be overlooked, however, that at least 80 per cent of the investment income of the insurance business is required to meet its liabilities, and, accordingly, even if included in the measurement of business income, it would not be taxed because liabilities incurred in operations are deductible.

Some would argue that the investment income is merely incidental to the insurance business, and to the extent it is required to meet the liabilities it should not be taxed. Viewed broadly, however, all the investments of an insurance company which produce income necessary to meet liabilities represent an alternative form of saving for the individual, and in this context the life insurance company is an investment conduit.

The avenues for investment now available are such that individuals have a practical alternative to saving through life insurance by combining personal investment with renewable term insurance, and the tax system should not discriminate between the two approaches.

The appropriate tax treatment of this aspect of life insurance therefore depends primarily on the treatment of the individual in respect of other forms of saving through pension plans, mutual funds, etc., which are dealt with elsewhere in the Report.

Effect of Tax Treatment on Industry Practice. Because the solvency of life insurance companies is important to the public interest, any method of taxing them that incidentally encouraged practices that tended to impair the solvency of companies could lead to difficulties. However we emphasized earlier that protecting the solvency of financial institutions is a matter for the applicable regulatory legislation and should not be regarded as a function of taxation. The impact of taxation should fall as evenly as possible on participating and non-participating business, and on stock and mutual companies.

Present Tax Treatment

Income Tax: Canadian Companies. The ordinary provisions concerning business income do not apply to a life insurance company. Rather, the income of

a company, by a special provision, is deemed to equal the amount credited to shareholders' account 24/. The amount so taxed does not include amounts credited to the non-participating fund contingency reserves, such as investment reserves or surplus, both of which are available to shareholders. In practice, the amount credited to shareholders' account is usually little more than that required to pay dividends on the shares. For example, while in 1964 revenues of Canadian insurance companies exceeded expenditures, including policy dividends and a normal increase in actuarial reserves, by $90 million, income taxes were paid on an amount of less than $5 million.

A deduction from taxable income is allowed to the company for the portion of the amount credited to shareholders' account that is considered to represent (on a pro rata basis) dividends received from taxable Canadian corporations and charitable donations made by the company. A pro rata share of profits and losses on investments is included in arriving at the taxable amount. In the same manner, a Canadian life insurance company includes in its taxable income a portion of the income from foreign operations. However, a tax credit is granted in respect of foreign income taxes, 25/ and, because the latter are usually much higher than the corresponding Canadian income tax, there is little or no Canadian income tax on foreign operations.

As mutual life insurance companies and fraternal benefit societies do not have shareholders' accounts, they are in effect exempt from income tax. Where a stock company is given permission to mutualize, the payments to shareholders to buy them out are specifically exempted from income tax under the Canadian and British Insurance Companies Act in the case of a federal insurance company, and under section 68B of the Income Tax Act in the case of a provincial company.

Income Tax: Foreign Companies Operating in Canada. There are no special provisions concerning Canadian branches of foreign companies, and, because foreign companies are considered to have no shareholders' accounts in Canada, they are not subject to Canadian tax on the business income from their Canadian

operations. The foreign companies are subject to non-resident withholding tax of 15 per cent on the portion of Canadian investment income which relates to assets in excess of 110 per cent of the Canadian liabilities 26/.

Premium Tax. A provincial premium tax of 2 per cent is levied on all insurance premiums less policy dividends.

Summary of Present Tax Revenue. Table 24-2 presents information on the income tax revenues in respect of life insurance business in 1964.

TABLE 24-2

INCOME TAXES ON CANADIAN LIFE INSURANCE COMPANIES

Canadian Income Taxes		
Federal	$1,631,557	
Provincial	295,217	$ 1,926,774
Foreign Income Taxes		$13,819,168

Note: In addition, Canadian companies paid premium taxes of $9,905,387 to Canadian provinces and $5,018,419 in foreign countries. Foreign companies paid provincial premium taxes in Canada of $4,966,705 and Canadian and non-resident shareholders paid about $300,000 in Canadian taxes on share dividends received from Canadian insurance companies.

Source: Department of Insurance.

With only about 30 per cent of the life insurance carried by Canadian companies being placed abroad, the $13.8 million paid by them in foreign income tax offers strange comparison with the mere $1.9 million paid in Canadian income tax. The foreign income taxes paid by Canadian companies may also be noted relative to the fact that foreign companies paid no income tax to Canada on a comparable amount of insurance placed by them in Canada.

Evaluation of Present Tax Treatment

In view of the main tax considerations discussed above, the present tax treatment of the life insurance business must be considered inappropriate and unsatisfactory for the following reasons:

1. The business income of a joint stock company is untaxed except for the portion which is credited to the shareholders' account in the financial statements.

2. There is no tax on the business income from mutual life insurance conducted by a joint stock company, except for a small percentage which may be withdrawn by the shareholders, nor on any of the business income of a mutual company.

3. The investment income generated in the life insurance business is considerable, and yet most of it is untaxed. This gives the holder of life insurance a tax preference over individuals who choose to save through some other investment form.

4. Because life insurance companies are virtually untaxed, the dividend tax credit is ineffective as an incentive to investment by them in Canadian equities. In fact, the existence of this credit tends to lower the rate of return before tax on equity shares and therefore to reduce their attractiveness for insurance companies as compared with other investments.

5. The business income of a Canadian branch of a non-resident insurance company is not subject to Canadian tax. Substantial tax may be levied on it in the country of residence.

6. While the mutualization of a life insurance company is permitted primarily to enable its control to remain in Canada, the procedure does enable surplus accumulated in a life insurance business to be distributed tax free.

7. Because the business income of life insurance companies is virtually untaxed, the other sections of the income tax legislation which impose restrictions on deductions are relatively ineffective. Primary examples are those relating to employer contributions to registered pension and other plans, charitable donations, and the rate of write-off of capital assets.

At the public hearings of this Commission it was suggested by the Canadian Life Insurance Officers Association that the present provincial premium tax serves as a substitute for income tax, but this does not appear valid either in principle or in terms of tax revenue. A tax on life insurance premiums is both a tax on saving and a tax on services. It is not a tax on income, and it is not a satisfactory substitute for an income tax.

It is not uncommon to tax both the income and sales of a business. Canada's present income and federal sales taxes do exactly this, and we recommend that services should be taxed in the same way as goods. The provinces have applied the premium tax to fire and casualty insurance premiums, even though these companies are also subject to income taxation. It may also be pointed out that in the United States the life insurance business is subject to premium taxes as well as to a comprehensive form of income tax. However, we have also advocated neutrality in tax treatment between competing organizations. Thus, it would not be equitable to continue a tax on life insurance premiums when savings invested through competing organizations are not subject to such a tax. Because the provinces would share in the tax revenues from life insurance profits, they might well decide to forgo the revenue from the tax on life insurance premiums. If not, then it would be hoped that the premium tax would be extended to apply to all forms of contributions to saving plans.

It has also been mentioned that income generated by insurance is taxed eventually because insurance proceeds are subjected to estate tax. The same could be said, however, of any form of income which is subjected to

tax and of which the unexpended amount is later subjected to estate tax. In any case, while insurance proceeds paid to Canadians in 1963 exceeded $600 million, only $50 million were included in assets on taxable estate tax returns.

Foreign Methods of Taxation

United States. Legislation which became effective on January 1, 1958 was the first attempt in the United States to tax the life insurance industry in a comprehensive fashion. Its provisions were designed to subject to tax the surplus which emerges each year in the same manner as corporate earnings generally. Under this legislation insurance companies are subject to tax on the following:

1. Taxable investment income, determined in the manner outlined below.

2. One half of the "underwriting gains", that is, of the excess of net income from all sources over taxable investment income.

3. Amounts distributed to shareholders or transferred to the shareholders' surplus account out of the policyholders' surplus account which arises from accumulations of the other half of the underwriting gains and of some other amounts which are deductible in computing underwriting gains.

In the event of an "underwriting loss", this is deductible in full from taxable investment income.

Taxable investment income is the insurance company's share of the investment income less investment expenses. This excludes the policyholders' share of investment income which is determined by applying to life insurance reserves an interest rate equal to the average earning rate of a company on all its assets for the five years ending in the taxation year.

In determining underwriting gains, an insurance company is entitled to deduct dividends to policyholders, except that if there is an underwriting

loss, policyholder dividends are deductible only to the extent of $250,000. In computing underwriting gains a company may also deduct 10 per cent of the increase in reserves for non-participating contracts or 3 per cent of the premiums for non-participating contracts, whichever is greater, and 2 per cent of the premiums for accident and health insurance contracts and group life insurance contracts.

Discussions with people familiar with the life insurance industry in the United States indicate that there are a number of technical difficulties in the legislation which have not yet been resolved. In view of the sudden increase in the tax burden on the industry, however, these technical difficulties are not surprising. What is more disturbing is that the industry is apparently having great difficulty in determining the tax implications of different management actions. Part of this difficulty arises from the fact that a sharp distinction is drawn between underwriting gains and taxable investment income. We understand that most of the present revenue is derived from taxable investment income.

In addition to the federal income tax, insurance companies are subject to premium taxes levied by the states, the most common rate being 2 per cent.

<u>United Kingdom</u>. In the United Kingdom the life insurance business is regarded primarily as an investment operation, and all the investment income, net of management expenses, but including the portion required for actuarial reserves, is taxed. The Revenue authorities have an option to tax an insurance business on its trading profit which is measured in a manner somewhat similar to that at present used in Canada, but apparently this is almost always lower than the investment income and is seldom used. Insurance premiums paid by individual taxpayers in specified circumstances are allowed to them as deductions from income for tax purposes.

Alternatives to Present
Tax Treatment

The main requirement of any alternative system of measuring the income from a life insurance business for tax purposes would be to impose some reasonable limit on the amount which could be set aside for future obligations, that is, the actuarial liabilities for future claims under outstanding policies. There is also a question of how the heavy initial expenses incurred in selling and writing an insurance policy should be treated.

Industry Practice. The simplest and most flexible approach would be to accept for tax purposes the provisions and write-offs established in the financial accounts of an insurance company. The amounts carried to surplus 27/ in the statements filed with the Department of Insurance could then form a basis for a regular tax on business income. This would amount to accepting for tax purposes procedures that have been developed for regulatory purposes. These purposes are usually in conflict because, while the first looks to the proper reporting of annual income, the second is concerned with protecting the policyholder. We have already stated our conclusion that regulatory goals can best be attained by direct legislation and that tax measures should not be used for this purpose, unless no other measure is available, because of the inequity that would result. Accepting the company statements would mean that the expenses of selling and writing insurance would be written off when incurred, a more liberal treatment than is now generally permitted to other taxpayers earning income under long-term contracts. Such a system would also create an inducement to defer tax by strengthening actuarial reserves by the use of lower interest rate assumptions. Such a deferment could have serious effects on tax revenue, because a conservative interest assumption in respect of amounts held for up to fifty years could prevent the emergence of surplus for a very long time. There would be some limit on the extent of such deferment because the Department of Insurance would discourage improper increases in reserves,

and competition in participating insurance requires the emergence of surplus for policy dividends. It is unlikely, however, that these influences would be sufficient to avoid undue deferment of taxation. There would be some discrimination as between different companies, because the large and well-established companies could more easily afford to strengthen their provisions for future liabilities without disrupting their financial positions than could their new and smaller competitors, but this discriminatory feature would not be unique to the life insurance industry. Because the liabilities recorded in each company's own records would determine its tax liabilities, there would be pressure on the companies to over-estimate their liabilities, an unfortunate result in view of the flexibility now enjoyed in this respect. In addition, such a procedure would allow the life insurance industry a degree of flexibility in computing tax liabilities that would not be available to other industries.

Arbitrary Assumptions for Tax Purposes. A second alternative for determining the amount of the actuarial provision that could be deducted in computing income for tax purposes would be to establish an arbitrary rate of investment yield. This rate might be struck as being reasonable for the long run and, for tax purposes only, all insurance companies would be required to adjust their actuarial provisions to reflect this factor. Alternatively, the arbitrary yield rate could be the maximum rate permitted under insurance legislation, this rate presumably being sufficiently conservative to protect solvency. Or again, the arbitrary yield percentage could be based on actual investment earnings of the individual company over an extended period of time. From the inquiries we have made, and from experience under the former methods of United States taxation, it appears that the use of a similar rate for all companies might not be entirely equitable because it would not reflect the individual circumstances of each company in relation to the nature of its investments and its policies.

On the other hand, there is evidence that any attempt to use different rates for different companies might lead to inequities and would certainly

cause administrative complexity. We regard this latter factor as extremely important, for if no system will produce complete equity because of the necessity for arbitrary guidelines, it is preferable to employ an approach that is readily understandable and can be administered with relative ease by both the taxpayer and the government. An arbitrary rate also makes clear beyond all doubt that, while fixed standards may be required for the practical necessities of taxation, for other purposes the evaluation of policy reserves by the management of individual companies should be undisturbed by tax considerations.

Excess Investment Yield as a Minimum. Because a substantial portion of the profit of an insurance operation usually arises from favourable investment experience, another alternative would be to ensure that the taxable business income was no less than the "excess" investment yield. This is an important feature in the United States method of taxing life insurance companies, and the formula is intended to identify the excess of the actual investment yield over that which would be needed if reserves (or accumulated assets) were limited to those needed under current yields. It appears, however, that this method might leave substantial profits untaxed, and involves an artificial segregation of investment and underwriting profits, which has proved to be one of the troublesome features of the United States system.

Annuities, and Accident and Sickness Insurance

The principal type of annuity written by insurance companies is the life annuity, the payment of which begins either immediately upon purchase or at some date in the future if the policyholder survives it. Insurance policies do not specifically provide for annuities, although such policies may provide for a lump sum convertible into an annuity at maturity. About 90 per cent of the total annuities now in force are group annuities, which are usually carried by employers for the benefit of employees.

The income of a life insurance company which is generated from its

annuity business is taxed in the same manner as the rest of its income. Therefore, the treatment of income from the annuity business must also be considered and co-ordinated with the tax treatment of the life insurance business. Annuity premiums are not subject to the provincial premium tax. Within limits, an individual may deduct contributions for annuities registered for tax purposes, the proceeds from which are fully taxable. Contributions by an individual for annuities that are not registered for tax purposes are not deductible, and only the interest element in the proceeds is taxable. The appropriate tax treatment of annuities from the annuitant's standpoint is discussed more fully in Chapter 16.

In general, the income of life insurance companies from accident and sickness insurance is taxed in the same manner as their income from life insurance. Because of the freedom which this procedure provides in setting up liabilities allowable for tax purposes, the life insurance companies have a competitive advantage over general insurance companies in the same field.

Proposed Tax Treatment

Our primary conclusion is that the present system of taxing life insurance business in Canada is quite inadequate 28/. A more appropriate tax system would recognize the emergence of annual income which accrues to the shareholders of the stock companies, to the participating policyholders of the mutual companies and the stock companies, or to the members of the fraternal benefit societies. We recommend that each of these groups should be taxed in a similar fashion. Experience in the United States suggests that the system should be as simple as possible and designed in such a way that its effect on business transactions will be predictable. Also, it should not be discriminatory between different types of business or different forms of organization.

Business Income. The computation of the business income of life insurance companies for tax purposes should be based on procedures which permit the

deduction of reasonable provisions for future liabilities; that is, of reasonable actuarial reserves. Such reserves for tax purposes should be calculated using an assumed arbitrary rate of investment yield, rather than actual investment yields. The use of an arbitrary and uniform rate would reduce complexity to a minimum. The rate to be employed should ensure that virtually all companies would deduct reserves which were not less favourable to them than would result from the use of their expected long-term investment yield. The arbitrary rate is recommended for administrative simplicity in determining income and is not intended as a means of accumulating contingency reserves. The provisions for future policy claims that are required to ensure solvency under the worst of conditions are not necessarily those that provide a reasonable reflection of income for tax purposes.

We believe that the above requirements dictate an arbitrary yield rate at the present time for Canadian life insurance actuarial liabilities of more than 4 per cent. The actual rate to be employed should be determined after discussions between the government and representatives of the industry. Our reason for suggesting a rate of more than 4 per cent is that the 20-year moving average of the actual investment yields earned on Canadian investments by federally incorporated life insurance companies has not dropped below 4 per cent in the 1900's 29/. We appreciate that the conservative investment valuation procedures employed by these companies tend to increase the yield rates. However, this overstatement is probably more than compensated by the omission of property gains from the computations. Therefore, a rate of over 4 per cent would permit the companies to report their provisions for tax purposes on a very favourable basis. The arbitrary rates could be changed if a long-term trend in investment yields warranted an adjustment. However, we would not expect such adjustments to be frequent.

The rate suggested above refers specifically to Canadian business. Because the yield on foreign investments acquired to provide for foreign liabilities is unlikely to be the same as for Canadian business, it would

not be equitable to apply the Canadian rate to all business. If our recommendations in Chapter 26 are accepted, there would be little difficulty in this regard because foreign source direct investment income from designated countries would then be eligible for an arbitrary foreign tax credit when received, regardless of the actual level of underlying tax. Nevertheless, some foreign source income would not qualify for such treatment, and in this case a different arbitrary rate should be determined, based upon the relative investment yields in Canada and the foreign jurisdiction.

Actuarial liabilities for tax purposes should be established on the net level premium basis.

In Chapter 22 we suggest that expenses which contribute to earning income over a number of years should either be written off as incurred or should be capitalized and amortized through capital cost allowances. The expenses of obtaining new insurance business should receive the same treatment as would be accorded to similar expenses by other businesses, namely, an immediate write-off of most expenses.

As in all businesses, gains or losses on investments should be included in business income.

The above recommendations concern the computation of tax liability only. The provisions for tax purposes should not depend in any way on what the companies record in their fiscal accounts.

All the above provisions are liberal when compared with our recommendations for industry generally. Under these provisions, a new life insurance business would not pay any income tax for a number of years, although most existing life insurance companies would immediately begin to pay substantial income tax. However, the impact on the shareholders of insurance companies of taxing life insurers on the full amount of their earnings would not be as substantial under our proposals as it would have been if the companies were subject to the full rates of tax under the present system, because the

integration of corporation and personal income tax would permit the tax burden to be limited to the personal rates of the resident individual shareholders.

However, in the case of a mutual life insurance company there would be no shareholders to whom undistributed earnings could be attributed, while in the case of a stock company most of the undistributed earnings from the participating business would be allocated to the policyholders and not to the shareholders. We have indicated in this Report that a corporation or other organization should not in itself be regarded as having a tax-paying capacity but as being an intermediary for the "owners", or the persons who have residual claims against it.

We have proposed that when the 50 per cent tax was levied on a corporation it should be entitled to allocate to its shareholders the earnings which had been subject to tax in the hands of the intermediary but had not been distributed in cash. Canadian residents would then include the amounts allocated to them in income, grossed-up to include the tax paid by the intermediary, and would obtain a credit for this tax. This procedure, if adopted, would apply to the shareholders of stock life insurance companies. A treatment which would be consistent in principle would be to permit stock companies to allocate to participating policyholders the earnings which arose from participating insurance (other than the shareholders' proportion of those earnings) and to permit mutual insurers to allocate to their participating policyholders all of the income which arose from their life insurance business. Canadian resident policyholders would then include in income the amounts allocated to them, grossed-up to include the tax paid by the insurer, and would receive a credit for that tax. However, in the case of income allocated to participating policyholders the situation would not be exactly parallel to that existing for shareholders. There would be the question of when, if ever, the accumulated income might be distributed to the policyholders. Also, as we recommended in Chapter 16 that mortality gains should not initially be subject to tax and as the policyholder interest in a life insurance policy is not readily marketable, there would be a question

of how the policyholder should record for tax purposes the amounts allocated to him. It would therefore be necessary for detailed regulations to be developed after discussions between industry and Department officials.

Policy Dividends. Consistent with our recommendations for other forms of mutual and co-operative activity which are contained in Chapter 20, policy dividends should be deducted in arriving at the business income taxable to the insurance company. The policy dividend should be treated as a distribution of business income and should be subject to a withholding tax of 15 per cent.

Investment Income. Discussion of the tax treatment of the investment income credited to policy reserves is contained in Chapter 16. The investment income in excess of that portion credited to policy reserves would, under the procedures discussed above, be included in income and taxed in the same manner as income of other corporations. Thus, the life insurance company would include dividends received from Canadian companies in its income on a grossed-up basis, and would obtain credit for the corporation income tax. This should prove to be a substantial incentive toward investment in Canadian equities.

Branches of Non-Resident Companies. Branches of non-resident companies should be taxed in the manner set out above for Canadian companies. Because non-resident companies do not ordinarily file operating statements with the Department of Insurance, a special calculation would be required, based on a proration of the results of the entire operations of each non-resident company. This would involve an allocation of head office expenses to the Canadian business and of a portion of policyholders' surpluses to Canada. To the extent that assets were held in Canada in excess of the actuarial reserves, the investment income on that excess could be taxed at the ordinary non-resident withholding tax rates as at the present time. In addition, it would be necessary to extend to life insurance companies the special tax on branch profits that is applicable to other businesses.

Administration. Under a comprehensive method of taxing life insurance companies, it does not seem reasonable to expect the Department of Insurance, which has responsibility for supervising industry practices, to ensure that policy liabilities will be met and also to determine whether the tax liability has been correctly calculated. Therefore, we suggest that certain members of the tax administration should become sufficiently familiar with the industry to be able to assess its taxation and that they should work in conjunction with the Department of Insurance.

Accident and Sickness Insurance. Income of a life insurance company from accident and sickness insurance should be taxed in the same manner as that recommended for the general insurance business in Chapter 25.

Interest on Funds Left on Deposit. Insurance companies pay interest on policy dividends and other policy proceeds that are left with them by policyholders. We understand that this interest is not always reported as income by the policyholder. Because the assets held on deposit are substantial, over $900 million in Canadian companies at the end of 1964, the requirements for reporting this income to the government and to the policyholder should correspond to those for investment income generally. Thus, the companies should be required to report the income and withhold tax of 15 per cent.

Effect on Tax Revenue. The revenue which would be produced by taxing income of insurance companies in the manner outlined above, based on its full application to 1964, is indicated in Table 24-3.

TABLE 24-3

APPROXIMATE TAX ON THE BUSINESS INCOME
OF LIFE INSURANCE CORPORATIONS
(millions of dollars)

Canadian Federal Companies—amount carried to surplus (less net losses on investments) plus the estimated adjustment resulting from the use of a 4 per cent rate to provide actuarial liabilities	$143 a/		
Less—Foreign portion, say, 30 per cent b/	44		
		$99	
Foreign Companies, say, two sevenths of the income of Canadian companies		41	
Total taxable business income		$140	
Corporation tax thereon at 50 per cent			$70 c/
Additional 15 per cent non-resident tax on branch income and on dividends paid to non-residents			5
Provincial companies and fraternal benefit societies			5
			$80 d/

a/ Amount carried to surplus, less loss on investments, per Report of the Superintendent of Insurance. — $90 million
Adjustment of actuarial provision for year to reflect an interest rate assumption of 4 per cent instead of the existing rates which appear to average out to approximately 3 per cent — 53
$143 million

b/ It was assumed that after allowing for foreign taxes on the foreign income of Canadian companies there was no additional Canadian tax to be paid.

c/ The tax paid at the corporate level would be offset by credits to resident shareholders of approximately $15 million and might also be offset by credits of most of the balance to resident policyholders if allocations to them were provided for.

d/ Subject to the effect of integrating corporation and personal income tax, this figure can be compared with estimated revenue of $2 million under the present system of taxation as detailed earlier in this chapter.

Transitional Provisions

Taxation of Business Income. Because the measurement of business income is based on earnings in excess of those required to meet liabilities, implementation of our proposals should not cause financial difficulties. The effect of our proposals on stock companies would be to levy income tax on the income as it was earned, rather than to wait until it was eventually distributed. Although this would only bring the taxation of shareholders of companies in the insurance business into line with the treatment of other shareholders, it would change what has amounted to a permanent tax deferral into an immediate tax liability. It should also be noted that under our proposals the burden of tax on income allocated to shareholders or participating policyholders would be limited to the rate of individual income tax applicable to the shareholders or participating policyholders. Nevertheless, our proposals would reduce substantially the future retained earnings and the cash flow of stock life insurance companies. It is possible that some portion of the taxes paid might be passed on in the form of higher premiums on new policies, and in the form of reduced dividends on existing and future participating policies.

The position for mutual life insurance companies would be somewhat different from that outlined for stock companies. Because the income of a life insurance company is at present only taxed when transferred to a shareholder's account, and because a mutual company has no shareholders, the mutual life companies are at present effectively exempt from taxation. In the case of both stock companies and mutual companies, the burden of tax on income attributable to resident policyholders might be limited to the rate of individual tax of those policyholders. The comments made above concerning the impact of these proposals on policyholders apply equally to policyholders of a mutual life company 30/.

Therefore, we recommend that our proposals should be implemented in full

immediately, with no provisions for a transitional period. We also recommend that all business income should be taxed, including the income derived from policies issued prior to the date of the implementation of our proposals.

Surpluses Accumulated Tax Free in the Past. A tax on the annual earnings of life insurance companies should take into account the treatment of surpluses accumulated tax free in the past. For Canadian insurance companies, such surpluses, including special contingency reserves, amounted to over $900 million at the end of 1964. 31/

It would be virtually impossible to impose taxation on surpluses accumulated in the past by foreign companies.

Surpluses accumulated in the past by mutual companies on all their business, and by stock companies on their participating business (other than the 2.5 per cent to 10 per cent share of participating business profits that could eventually be credited to the shareholders), are exempt from tax under the present legislation, and accordingly tax should not be imposed on them. The surpluses remaining, mainly from the non-participating business of Canadian stock companies, are taxable under the present legislation upon transfer to shareholders, and, accordingly, provision might be made to tax them under new legislation. The amount of such surpluses relating to Canadian business, including the recommended adjustment of actuarial liabilities, would amount to almost $300 million. Alternatively, it could be argued that in the ordinary course of events the tax on surpluses accumulated in the past would have been postponed indefinitely under the existing legislation, and that to tax them now would discriminate against the stock companies. It should also be noted that most of the surplus retained by the insurance companies has not yet borne any corporation tax.

We recommend that the surplus on hand at the effective date should continue to be subject to the 50 per cent corporation income tax if and when

it is credited to shareholders' accounts, but when paid out in the form of dividends it should be treated in the same manner as for other corporations, that is, as a reduction in the cost basis of the shares.

Another transitional problem concerns the opening balance, for tax purposes, in the provision for actuarial liabilities. At present, all companies use an investment yield rate of 3.5 per cent, or less, for determining their life insurance liabilities, while we recommend that a rate higher than 4 per cent should be employed. We recommend that, for tax purposes, the surplus accounts at the effective date should be increased by the amount required to reduce the provision for actuarial liabilities to the amount determined under the new rate to be employed.

CONCLUSIONS AND RECOMMENDATIONS

BANKS, TRUST COMPANIES, MORTGAGE AND LOAN COMPANIES, AND FINANCE AND CONSUMER LOAN COMPANIES

1. Financial institutions should, in general, be taxed in the same way as other taxpayers. Federal and provincial legislation provides for the solvency and liquidity of most of these institutions, and we do not feel that income tax legislation should be made to help serve the same purpose.

2. The treatment of the reserves of financial institutions should be altered to conform to general practice as followed in determining taxable income of other taxpayers, and should not provide for contingencies. However, to reduce complexity and uncertainty these institutions should be allowed to provide for losses on designated kinds of loans on an arbitrary basis, as an alternative to the specific valuation of individual loans. The present use of arbitrary allowances for banks and mortgage lenders should therefore be continued, but, the level of rates should be considerably reduced. In the case of banks the rate should be reduced from approximately 3.5

per cent to variable rates, applicable to fewer assets, of something less than 2 per cent, and, in the case of mortgage lenders, from 3 per cent to about 1 per cent on most mortgages and to something less than 2 per cent on the riskier mortgages. In the case of banks only, an alternative arbitrary allowance against loans of up to seven times the average loss experience for the previous five years should also be available on an optional basis.

3. Federal and provincial securities with maturities exceeding one year which are held by financial institutions should be valued on an amortized basis, and should be eligible for an arbitrary allowance of one half of 1 per cent of the amortized value.

4. The special provisions with respect to mortgages contained in section 85G of the Income Tax Act should be extended to all taxpayers (except banks), whether or not they are in the mortgage business. The exclusion of insured mortgages should be extended to privately insured mortgages, and the percentage rates should be reduced as indicated above.

LIFE INSURANCE COMPANIES

5. The business income of resident insurance companies, whether organized as stock or mutual companies or as fraternal benefit societies, should, in general, be determined and taxed in the same way as the business income of companies in other industries.

6. An arbitrary investment yield assumption should be specified for use in estimating the actuarial liabilities for tax purposes. A rate exceeding 4 per cent would appear to be appropriate for determining life insurance liabilities.

7. Policy dividends (except those paid out of surplus existing at the effective date of the legislation) should be deductible in computing the income of the paying company and should be included in the incomes

of the recipients. They should be subject to a withholding tax of 15 per cent.

8. The business income of Canadian branches of non-resident insurance companies should be taxed in the same manner as the business income of resident companies. They should also be subject to the same tax on branch income as is applicable to other non-resident companies with branches in Canada.

9. Resident insurance corporations should be entitled to follow the gross-up and credit procedure in respect of dividends from resident companies that we recommend in Chapter 19.

10. Stock companies should be entitled to allocate to shareholders the income which is attributable to them in the same manner as any other corporation. It would also be desirable for both stock and mutual companies to allocate to participating policyholders the income which is attributable to them. The amounts allocated to resident shareholders and policyholders would be included in their incomes, grossed-up to include the corporation tax, and they would be entitled to credit for the corporation tax.

11. Interest on funds left on deposit with insurance companies should be reported to the tax authorities and should be subject to a 15 per cent withholding tax.

12. Surplus at the effective date of the legislation should be adjusted for tax purposes to reflect the revision of actuarial liabilities. Such surplus would continue to be taxable if credited to shareholders' account.

REFERENCES

1/ The chartered banks, for example, had over two and a half million individual loans outstanding at June 30, 1965, amounting to $10.5 billion. A few large retail organizations have this problem in common with the financial institutions, but their income is derived primarily from trade rather than from the business of lending money and provision for losses on receivables therefore is not as significant in income determination.

2/ This deduction is allowed under section 11(4) of the Income Tax Act. The deduction in computing income is permitted only of "such amount as is set aside or reserved", so that banks are limited to the lower of the maximum permitted reserves or the amount set up in their books as valuation reserves. Notwithstanding section 11(4) of the Income Tax Act, it would appear possible for a bank to claim a deduction alternatively under section 11(1)(e) and this conceivably could exceed the amount allowable under section 11(4). However, it is extremely unlikely that a bank would do so.

3/ Bank Act, S.C. 1953-54, Chapter 48, section 63(1).

4/ Royal Commission on Banking and Finance, Report. Ottawa: Queen's Printer, 1964, p. 386.

5/ Section 85G of the Act deals with loans "made...on the security of a mortgage, hypothec, or agreement of sale of real property". However, mortgages or hypothecs under the National Housing Act, 1954 or any of the Housing Acts as defined in paragraph (e) of section 2 of the Central Mortgage and Housing Corporation Act are excluded. The section was introduced in 1955 and was designed to permit, over a period of time, a maximum reserve of 3 per cent of the principal amount of mortgage loans outstanding plus interest due and unpaid on those loans. The rate of accumulation of the reserve was limited to

one quarter of 1 per cent a year, but was changed in 1965 to one half of 1 per cent a year. The Trust Companies Association of Canada in their submission to the Commission, pointed out that the former limitation was such that a company with annual increases in mortgage loans outstanding would not reach the 3 per cent maximum at any time in the future. However, the change in the limitation should ease this problem and the percentage reserved should move toward the maximum.

6/ Section 11(1)(e).

7/ Depreciation provisions constitute an important determinant of income for many businesses.

8/ Disputes may also arise over the right to make deductions. For example, the right of acceptance companies to claim losses in respect of wholesale or retail "paper" purchased has never been clearly established, but by departmental practice such claims have been allowed because the finance contracts have been regarded as "accounts receivable" or "inventory". In Ted Davey Finance Co. Ltd. v. M.N.R., [1965] Ex. C.R. 20, the Exchequer Court threw some doubt on this practice by finding that (1) a sale of such commercial paper was not a sale in the course of trade, (2) section 85D dealing with the sale of accounts receivable did not apply, and (3) the commercial paper was not "inventory".

9/ The fact that the anticipated income has not been earned, of course, does not affect the loss potential.

10/ Bank of Canada, Statistical Summary, February 1965, p. 90.

11/ Royal Commission on Banking and Finance, Report, op. cit., p. 386.

12/ Computed from Superintendent of Insurance, Report on Small Loan Companies and Money Lenders Licensed Under the Small Loans Act, Ottawa: Queen's Printer, 1963.

13/ The following percentage distribution of loan accounts outstanding by size at September 30, 1962, was prepared from figures in Royal Commission on Banking and Finance, Report, op. cit., pp. 132 and 134.

Category	Under authorization of:	No. of Accounts (per cent)	Outstanding Amounts (per cent)
1	Less than $10,000	96.3	30.9
2	$10,000 to $100,000	3.1 a/	19.4
3	$100,000 to $1,000,000		23.6
4	$1,000,000 or more	.6	26.1
		100.0	100.0
Number and Amount		2,068,105	$7,033,000,000

a/ This figure pertains to categories 2 and 3.

14/ There are few published data on mortgage losses. Information concerning a major mortgage company and information supplied by the Department of Insurance relative to Canadian life insurance companies suggest that the average annual net losses over this period have been approximately one fifth of 1 per cent. When a mortgage is foreclosed, the eventual loss is usually only a small proportion of the amount defaulted.

The Dominion Mortgage Association has completed a survey of its members for the 1929 to 1948 period that shows an average annual loss allowance of just over two thirds of 1 per cent. However, representatives of the Trust Companies Association pointed out that losses since 1948 have been virtually non-existent. The annual average loss experience is only significant in indicating the magnitude of the losses that will be chargeable against the allowance. Therefore, perhaps a more useful comparison is the insurance fee of 2 per cent charged on the initial value of National Housing Act mortgages. In this case, it would appear that the allowance built up with these fees will be quite sufficient to take care of expected losses, even though the risk of loss on such mortgages is considerably greater than on most conventional first mortgages.

15/ The write-off for tax purposes itself does not affect the taxpayer's right of collection.

16/ See Chapter 22 for further discussion on the meaning of "loss".

17/ Figures supplied by the Department of National Revenue for nine companies in the mortgage business indicate a tax allowance at the end of 1963 of under 2 per cent in all cases. Three companies had an allowance of under 1 per cent, and all but one were under 1.5 per cent. However, the 1965 legislative amendment permitting a larger annual provision will have caused some increase in the percentages.

18/ Figures supplied by the Department of National Revenue for six finance companies indicate that the tax provision at the end of 1963 ranged from one quarter of 1 per cent to 2 per cent of outstanding accounts.

19/ The cost of protection and the benefits derived therefrom affect the taxable capacity of the individual. The appropriate tax treatment of the individual is considered in Chapter 16.

20/ Fraternal benefit societies may alter the terms of their contracts by by-law, but rarely if ever do so in practice.

21/ Summary for the five companies which mutualized (thousands of dollars).

Companies	Total Amount Paid for Shares	Capital Account	Surplus in Share-holders' Fund	Excess (Paid out of Policy-holders' Surpluses)	Policyholders' Surpluses as at December 31 of Year Prior to Start of Mutualization: Non-Parti-cipating	Parti-cipating
Canada Life Assurance Co.	$22,000	1,000	1,208	19,792	9,224	20,882
Confederation Life Assoc.	18,000	1,000	719	16,281	13,402	16,548
Equitable Life Insurance Co.	4,253	327	400	3,526	2,488	(1,077)
Manufacturers' Life Insurance Co.	41,250	1,500	2,234	37,516	14,736	23,812
Sun Life Assurance Co. of Canada	65,000	2,000	2,426	60,574	21,338	129,019

Source: Information supplied by the Department of Insurance.

22/ It should be noted that the investment yield assumption employed in setting premiums might be slightly higher than that used in calculating policy reserves.

23/ Although the participating policyholder, unlike the co-operative member, has no contractual right to share in surplus earnings, nevertheless the participating policyholders as a group have ultimate ownership of the surplus earnings of the participating business, and the suggested treatment would reflect the extent to which this participation takes place.

24/ Section 30.

25/ Income Tax Act, section 41(3) and Regulations, Part XXIV.

26/ Regulations, sections 802, 803.

27/ The amount carried to surplus does not include the regular actuarial provisions for future policy claims and policy dividends; it does include an adjustment for profits and losses on disposal of investments, special increases in provisions for future policy claims, changes in special reserves, and dividends to shareholders.

28/ We discuss the treatment of policyholders in Chapter 16.

29/ See Chart 24-1.

30/ Our recommendations concerning policyholders, including those who receive policy dividends, are given in Chapter 16.

31/ Adjustment of accumulated policy reserves to reflect the proposed arbitrary rate would increase this amount by over $800 million.

CHAPTER 25

OTHER INDUSTRIES

FARMING

In 1961, Canadian commercial farms, defined as farms with sales of agricultural products of $1,200 or more, numbered some 353,000. In the same year over 200,000 individual farmers filed tax returns, of whom some 74,000 paid about $27 million tax on a total income of approximately $323 million. Table 25-1 gives this information by provinces.

TABLE 25-1

Province	Total Commercial Farms (1)	Number of Farms with Sales over $5,000 (2)	Number of Farms with Sales over $10,000 (3)	Number of Farmers Reporting Taxable Income (4)	Income Reported by Taxable Farmers (thousands of dollars) (5)	Taxes Paid (thousands of dollars) (6)
Nfld.	456	169	93	n/a	n/a	n/a
P.E.I.	4,530	1,210	315	168	579	34
N.S.	4,939	1,569	633	333	1,318	97
N.B.	5,116	1,582	597	434	1,865	144
Que.	62,497	15,722	3,871	1,031	4,761	429
Ont.	90,345	43,091	19,190	19,339	90,262	8,086
Man.	33,522	12,191	3,225	5,945	22,219	1,371
Sask.	82,285	33,251	8,961	24,361	103,753	8,130
Alta.	58,698	26,186	10,210	19,000	83,427	7,229
B.C.	10,902	5,289	2,746	3,491	14,754	1,287
	353,290	140,260	49,841	74,102	322,938	26,807

Sources: Columns (1)-(3). Dominion Bureau of Statistics 1961 Census of Canada: Agriculture, Bulletin 5.1-1, Ottawa: Queen's Printer, 1963, p. xii.

Columns (4)-(6). Department of National Revenue, Taxation Statistics, 1963, Ottawa: Queen's Printer, 1963, Section II, Table 8.

The taxation of farming income must take into consideration the special characteristics of this natural resource industry, the vagaries of nature and markets, the prevalence of small individual operators, and the close relationship of personal and business activities. On the other hand, if equity is to be achieved, the importance of these special characteristics must be considered in comparison with those encountered by taxpayers in other lines of endeavour. In making this comparison it is necessary to keep in mind the changes which have been taking place in agriculture and, in particular, the increase in the size of the farm unit, the increased technical assistance from government authorities, improved marketing arrangements, and the increased use of scientific knowledge and business methods.

In the Canadian tax system there are numerous provisions and practices designed for the special circumstances of farming. Statutory provisions in the Income Tax Act permit the cash basis of reporting income 1/ and the averaging of farm income, 2/ and restrict the deduction of "hobby" farm losses 3/. The Regulations permit straight-line depreciation 4/. Departmental practice provides, under the "basic herd" directive, 5/ for the treatment of productive livestock as a capital asset.

In general, we have found that many of the special tax provisions and practices are no longer appropriate. Because of the changing nature of the industry, farmers, or at least those with larger incomes, should now be able to report income on a basis similar to that followed by other small businessmen. Special tax treatment intended to meet the special circumstances of agriculture has in turn led to significant inequities, anomalies and loopholes, and to administrative difficulties. These are discussed below.

Cash Basis of Computing Income

Income from farming or a profession may be computed on a cash basis under the present tax legislation, whereas income from other businesses is basically the "profit" therefrom, such profit being generally determined on

the accrual basis. Because the cash basis seldom gives an accurate measure of income, and usually results in an understatement of income because of the non-recognition of assets, we recommend that its use should be prohibited unless the farmer is an individual whose principal source of income was farming and his gross revenue from farming was less than a specified sum, say, $10,000. This recommendation has many implications for agriculture.

The failure of the cash basis to reflect accounts receivable and payable would not materially affect the income of most farms, but its failure to take inventories into account is serious because of the substantial inventories of livestock or grain which are maintained on many farms. In such cases, the cash basis permits the cost of building up the inventories to be deducted immediately, thereby giving the farmer the advantage of a tax deferment equal to the tax which would have been exigible on an amount equal to the cost of the inventory. It is true that the advantage under the present tax system is only a deferment of tax in that the cost would ultimately be allowed as a deduction; however, the deferment is equivalent, in relative terms, to an interest-free, unsecured loan, which could be of material amount, and is not granted to business generally.

The cash basis of computing income has also created an extra incentive for wealthy individuals to establish a farm as a secondary endeavour, because losses reported for the early years of operation would be artificially high due to the write-off of the costs of building up inventories and other assets.

The cash basis of computing farm income also produces results which would be unfavourable to the farmer, and has necessitated special relieving treatment. For example, upon a dispersal sale of a herd due to the death or retirement of a farmer for any other reason, the entire proceeds would be subject to tax in one year under the cash method. When a farmer is engaged in producing livestock or livestock products for sale, this problem has been relieved by the practice of treating the original purchase and ultimate sale of a basic number of animals as a capital non-taxable transaction. This is based on the

principle of the "basic herd". This procedure has been satisfactory to the farming community, but it is unauthorized in the legislation and, as will be explained below, it has produced anomalies and loopholes. It is also questionable in principle, even under the present tax system, let alone under the comprehensive tax base which we propose.

There are therefore compelling reasons for requiring farm income to be computed on an accural basis; there remains the question of whether there would be undue difficulty for the farmer in computing income on this basis. It is likely that the cash basis for farm income became established, by practice and legislation, mainly because of the rudimentary records and business practices used in the industry in the past. However, an evolution has been taking place in farming in recent years, with an increase in the size of an economic farm and an attendant increase in capital employed in buildings and machinery; successful farming operations are now more similar to those of business generally. In view of these developments and the fact that only about one farmer in ten is taxable, we believe that most of the taxable farmers are probably already maintaining sufficient information to adjust cash records to an accrual basis. This is not to say that an exact determination of farm income could be expected, because the typical farm represents a complex manufacturing operation. We therefore suggest that the tax authorities, in consultation with representatives of the industry, develop guidelines for methods of valuing inventories at the lower of cost or market. The objective, it should be emphasized, is not to take up revenue before it is realized, but to defer the deduction of the cost of inventories until their disposal.

<u>Special Problems in Valuing Livestock</u>. The principle of a basic herd, that is, a number of cattle treated as a capital asset, was established under a directive of the tax authorities to relieve the problem faced by a farmer upon a dispersal sale when he had been computing income on a cash basis. Under this procedure a farmer may elect to set up a certain number of cattle as a

basic herd, in which case he does not deduct their cost from income and, upon reduction in the number of such animals by sale, the proceeds are not taxable. As we have said, this procedure has proved satisfactory to the farming community, and we received some representations that it should be supported by legislation.

Upon detailed examination, however, we have found that the basic herd procedure is an undue administrative burden and results in significant inequities and anomalies. For example, because the practice of treating productive livestock as a capital asset is not supported in the legislation, and probably would not be supported by the courts, it has remained possible for a farmer to claim a loss on disposal of a basic herd.

We understand that it has proved very difficult to determine for an established herd the number of animals whose acquisition costs did not reduce taxable income. For example, if a farmer has been on a cash basis, and a herd had been established in years for which records are no longer available and when losses as well as profits were incurred, it is not possible to establish whether the purchase price of the animals had reduced taxable income. We understand that most of the farmers applying to use the basic herd principle recently have been those who have had herds since 1947, and that this problem of establishing whether the animals' costs had been charged against taxable income still persists. For a farmer who has consistently been on the accrual basis, it is evidence that the acquisition costs had not been charged to taxable income to the extent that an inventory value was set up. However, in view of the method of inventory valuation which will be referred to below, the capitalization of the basic herd can be achieved at arbitrarily low values.

We have therefore concluded that the basic herd procedure should be discontinued except in those cases in which the farmer is permitted to continue his accounting on the cash basis. The continuance of this restricted use of the basic herd procedure should be established by legislation. The

difficulty arising upon the dispersal sale of a herd when using the cash basis of reporting income will not arise to the same extent under the accrual basis of accounting. Where there are abnormal profits resulting upon the final realization of a herd, the farmer will have recourse to the averaging provisions which we recommend. Because of the difficulties of ascertaining the actual cost of productive livestock, its inventory value might best be determined by using a conservative proportion of market value.

We should also mention section 1802 of the Regulations which, in general terms, permits a cattle breeder to value each animal of a species for inventory purposes at the same value as in the closing inventory of the previous year, or, if it is a new species, at a value comparable to that used by other taxpayers in the taxation district. In view of our general recommendations in Chapter 22 that inventories should be valued at a reasonable approximation of cost and that business inventories generally should be related to current costs even under the last-in-first-out method, this particular regulation for cattle breeders represents an unjustified exception and should be removed.

Transitional Features. The adoption of the accrual basis by taxpayers now on the cash basis would involve the immediate imposition of tax on the value of inventories and accounts receivable less accounts payable. Although this would only result in the immediate collection of tax that would have eventually been paid, in many cases it could result in severe hardships. We therefore recommend that the cost basis of the farm land as at the transition date, which would be its fair market value at that date and which would have to be determined for the taxation of property gains in any event, should be reduced by the amount of the net adjustment required to put the farm business on an accrual basis (in the case of the farms which go on that basis). The effect of this adjustment would be to defer bringing into income, until the farm was disposed of, the amount of the accrual adjustment.

Further discussion of the accrual adjustment is contained in Chapter 22 as it would apply to all businesses now on the cash basis. In Chapter 22 we

recommend that the requirement to compute income on the accrual basis should not apply in cases where gross revenue was less than, say, $10,000 a year pending the rendering of assistance to these small businesses in putting their records in order. Where a cash basis was continued, so also should the use of a basic herd be continued if applicable.

The tax value of the basic herd should also be increased to current market values, but in this case the amount of this adjustment should be regarded as a tax-free gain as would be the case on a sale of the basic herd under the present practice. This would involve a valuation of the basic herd as at the effective date of the legislation.

Personal Aspects of Farming

The segregation of personal and business factors is particularly difficult in farming operations in two main respects. First, the farmer usually lives on the farm, and consequently there has to be an apportionment of specific expenditures on the house into business and personal elements, and an identification of the produce consumed personally. Second, while almost every farming enterprise involves certain expenditures of a personal nature, there are some situations where a farm operation as a whole is carried on for personal rather than commercial reasons.

Specific Expenditures. The deductibility of specific farm home expenses is governed by the general provisions of the legislation applicable to income from a business or property, which allow a deduction for expenses incurred for the purpose of earning income, 6/ if they do not represent personal or living expenses 7/. In applying these provisions to farming, the following guidance is given in The Farmers' and Fishermen's Guide, published by the tax authorities:

> "If the home on your farm is used to earn farm income you may claim an amount not exceeding one quarter of all repairs to the home and a reasonable portion of the cost of light, power, taxes, telephone and fire insurance.
>
> "For a farm home, the capital cost allowance is based on not more than one fourth of the cost."

In practice, it is understood that the total cost of light, power, taxes, telephone and fire insurance is usually allowed. If the house is more luxurious than normal, the deduction permitted may be lower.

It appears to us that this practice is not in accordance with the provisions of the legislation referred to above, and we recommend that it be brought into line with that accorded other taxpayers such as doctors and storekeepers who use certain facilities both for business and personal purposes. If the determination of a reasonable portion in each case is too difficult to administer, a small percentage of all farm home expenses might be universally allowed, additional amounts being permitted only where supporting evidence was given to justify it.

With respect to farm produce consumed personally, the practice is to add to the income of the farm the out-of-pocket cost of such produce, and this appears satisfactory because it does not seem practical to impute an element of profit to it even though the economic benefit is greater than the cost.

"Hobby" Farming. There remains for consideration the treatment of those farm operations carried on as a hobby or sideline 8/. The motives may be varied: a natural interest in agriculture, a country place for recreation, future land development, creation of an asset out of what otherwise would have been highly taxed income (especially if the farm operation is reported on a cash basis), and so on. Aside from the proper separation of the income from the business element, how is the personal element to be segregated? When does it become predominant?

The general approach under the present legislation is to limit the deduction of a farm loss in a year to a maximum of $5,000 where the taxpayer's chief source of income for the year is neither farming nor a combination of farming and some other source 9/. Any balance of a loss unabsorbed may be applied against farming income in other years under the ordinary loss carry-over rules. This provision has, however, had a two-sided effect: a limitation on one hand but, on the other, an apparent invitation to claim a limited

deduction for any farming operation. We do not have any exact figures of the farming losses claimed by individuals in occupations other than farming 10/. Unpublished figures supplied to us by the Department of National Revenue for taxpayers in Canada reporting income of over $100,000 in 1960 show that, out of 549 such taxpayers, 59 reported farm operations and 52 reported losses. Of these losses, 31 were in maximum amount of $5,000. In view of the prevalence of losses in these part-time farm operations, it is perhaps reasonable to conclude that many of them were maintained for predominantly personal rather than business purposes.

Modifications can be made to improve the present legislation. We recommend that accrual accounting be required for larger farm operations, that a more concerted effort be made to disallow for tax purposes expenditures of a personal nature, that there be a reduction in the top personal rates of tax, and that gains on land transactions (above the recommended exemption for specified cases) should be included in the tax base. These measures should lessen the incentive for taxpayers to use farming of a personal or hobby nature for their tax advantage.

Another possible change could be the removal of ministerial discretion in connection with the "chief source of income" test, and basing that test on farming activity over a number of years rather than on one year. Alternatively, a maximum lifetime limit, say, $15,000, could be placed on the net amount of farm losses which could be claimed against other income, the balance of any losses to be allowed only against farm income in the future. This would give the bona fide farmer some time to get established, but after that he would have to make profits in some years in order to claim losses of other years.

We concluded, however, that the existence of "hobby" businesses was not limited to farming, and that, as part of an effective prohibition against the deduction of personal expenditures, it would be necessary to adopt a broader legislative provision. In addition, we concluded that further attempts to define "hobby" farming were unlikely to be any more successful

than past efforts, and that a more arbitrary and certain guideline was needed to indicate when losses should be disallowed as being of a personal consumption nature. Therefore, as we indicate in Chapters 9 and 22, we recommend that, once a business has had losses in three years out of five, it should thereafter (until it had made sufficient income from the same business to recoup such losses) be deemed to be a "hobby" business, and subsequent losses should not be allowed as a deduction from other income but should be carried back two years and forward indefinitely only for deduction from income (if any) of the same business. The five-year period is suggested for ease of administration, but if the use of such a period permits some taxpayers to deduct recurring losses of a personal expenditure nature then it should be extended. It should be noted that this proposal is considerably more liberal than the present hobby farm provision as it would permit an unlimited write-off against other income of the losses in the first three loss years. It should also be pointed out that we recommend in Chapter 22 that a business should not be required to reduce its income (or produce a loss) by claiming capital cost allowances.

In view of the more general provision proposed above, section 13(1), which now restricts the deduction of farming losses from other income, should be withdrawn.

Income Averaging

Under the present legislation, a taxpayer whose chief source of income is farming (or fishing) is entitled to average his income for a five-year period and pay tax as if his income for each year had been the average amount 11/. It is a "block" type of averaging under which the periods of averaging cannot overlap.

Subject to technical limitations concerning the "chief source of income" test, it appears that these averaging provisions have operated satisfactorily to even out the fluctuations of farm income which result from the unpredictable

effects of nature and markets. The need for such averaging still exists but, in view of our recommendation in Chapter 13 to permit all taxpayers to use a method of averaging, the present limited provisions applicable to farmers should be repealed.

Capital Cost Allowance

When the general change from the straight-line to the diminishing balance method of depreciation was made in 1949, farmers (and fishermen) were permitted to continue on the straight-line method if they wished 12/. It is difficult to see why this exception was made, because there appear to be no special circumstances which make the straight-line depreciation method more suitable to farming than the diminishing balance method. In fact, the reverse would seem to be true, for the diminishing balance method is simple to operate, and usually provides a better measure of the loss in value of depreciable assets on the farm. In addition, the exemption from tax of recaptured depreciation on the disposal of depreciable assets under the straight-line system is an inequity and has led to abuse. Accordingly, we recommend that this exception to the application of the diminishing balance method should be removed.

In Chapter 22, we discuss the general problem of "nothings", or expenditures that are not deductible under the present legislation. Our recommendations in that chapter would apply equally to farming, and would ensure that all expenditures reasonably related to the earning of farm income would be deductible, either in the year incurred or through capital cost allowance.

One specific category of asset should be mentioned. At the present time no deduction is permitted for the capital cost of orchards. This treatment is unrealistic, and we recommend that orchards should be treated like other depreciable assets.

Sale of Depreciable Property to a Child

Section 85H of the Income Tax Act provides that, where a parent sells depreciable farm property to his child, the price paid, provided it does

not exceed fair market value, will be recognized as the capital cost to the child, even though the price may have exceeded the original cost to the parent and thereby have created a non-taxable gain to the parent. Aside from the fact that this provision also applies to certain fishing assets, this is the only exception to the general rule in the present legislation 13/ that on a sale of depreciable property between related persons the depreciable amount cannot be higher than the capital cost to the vendor. At the present time, therefore, the farmer has considerable freedom in setting the price at which he sells depreciable property to his child, for if it is at a nominal price it does not offend the fair market value rule (which is generally not applicable to depreciable property transferred between related persons) 14/; and if it is at fair market value, the price constitutes the capital cost to the purchaser even though it may create a non-taxable gain to the vendor.

Because all proceeds on disposal of depreciable assets would be taken into account for tax purposes under our proposed system, we make the general recommendation in Chapter 22 that the fair market value test should be extended to depreciable assets transferred between related persons, and we recommend that this general rule should also apply to depreciable farm property. It may be contended that this would impose hardship because it would force a farmer to sell his property to his child at nothing less than fair market value. However, not only is this treatment the same as that proposed for property generally and for other kinds of business but, in addition, the farmer would be eligible for the lifetime exclusion of $25,000 for realized gains on residential and farm property that we recommend in Chapter 15. Thus, the owner of even a moderately sized farm would normally be exempt from tax on the disposition of his farm, and the purchaser, for example, his son, would be able to claim depreciation on the fair market value of the property acquired. The only change in most cases in which a farmer transferred a farm to his son would be the requirement to recapture depreciation.

If a farm operator wished to confer a benefit on his child by transferring the farm at less than fair market value, it should be recognized

for what it was, a gift, and should be subject to the usual rules set out in Chapter 17. It should be noted that, if the proposed lifetime exemptions for gifts received had not been used up by the son's family unit, a transfer at a price below market value would be exempt from tax to the extent of $5,000 for each of the son and his wife.

Sale of Farm Land

In accordance with our comprehensive tax base, any gain realized on a disposal of farm property would be taxable. We recommend in Chapter 15 that such a gain should be eligible for the lifetime exemption of $25,000 which applies to gains on the sale of residential properties and farms.

Revenue Effects

The most important of our suggested changes in terms of revenue would be the adoption of accrual accounting, which would not permit the deduction of the cost of increasing inventories 15/. In addition, net changes in accounts receivable and payable would be taken into account in computing income. The exemption from tax of profits on the disposal of basic herds would disappear.

The stricter segregation of personal expenditures on the farm, and the stricter treatment of farm operations carried on for personal rather than commercial reasons, would produce some additional revenue. Adoption of the diminishing balance method of depreciation would tend to reduce tax revenue. Against this, however, tax revenues would be increased by taxation of depreciation recaptured upon disposal of depreciable assets.

In terms of overall income tax revenue, these changes should not be material. On balance, there should be some increase 16/.

FISHING

This natural resource industry has characteristics similar to those of farming. It is affected by the vagaries of the weather, the fluctuation in the supply of fish due to disease and changes in the life cycle, and the prevalence of many small operators.

The specific provisions in the legislation for the farming industry concerning income averaging, the use of straight-line depreciation and the sale of depreciable property to a child also apply to the fishing industry, as do our recommendations regarding them.

FORESTRY

As a natural resource operation, forestry may be viewed as a unique kind of long-term crop. Like other crops it is renewable, but a very long time is involved in the process. Furthermore, it may not be possible to obtain a new crop similar to the previous one, so that a timber stand is a constantly changing asset. These basic characteristics, together with the great variety in forms of ownership, have created problems in measuring income for tax purposes, especially by reason of the application of the distinction between capital and income which has been followed in Canada.

Measurement of Income

A measurement of the change in real value of a privately owned forestry operation would have to take into account the imperceptible increase naturally occurring in the value of the timber. Aside from the difficulty of making such an estimate, the amount estimated, even if accurate at the time, might be subject to considerable subsequent variation. In the long period of time before realization of income, changing markets, technology, and the natural hazards of fire and disease could make the previous estimate quite inaccurate. An annual period of measurement is clearly inappropriate for forestry and, accordingly, the measure of the income of a forestry operator for tax purposes in terms of annual change in economic power is bound to be imprecise.

Deduction of Cost

Public and Private Ownership. Most of the productive timber resources in Canada are provincially owned, and a stumpage charge is imposed on the forestry operator at the time of cutting. For the privately owned forest there would have been an initial cost of acquiring the property, and the main recurring cost paid to government is property taxes. Both types of forest are subject to other recurring costs such as fire protection and surveying. To determine whether there is any serious discrimination between public and private ownership, a comprehensive review of all types of costs and the various provincial and municipal taxes would be required. This is clearly beyond the scope of this Commission, but at least we must consider the effect on income taxation of the time at which costs are allowed.

We have considered whether the private owner who has to carry an investment in timber resources would be on a more nearly equal footing with a lessee of timber resources if he were allowed an immediate deduction for his investment. It appears to us that there is some merit in this suggestion, but on the other hand there are advantages to private ownership which offset the burden of carrying an investment. These include the ready availability of a source of raw material and, in some cases, the right to harvest crops indefinitely in the future. From the evidence presented to us it appears that private ownership of timber resources is valuable, and accordingly, we do not see any need for an immediate deduction by private owners of the cost of timber limits.

At the other end of the scale, we considered whether the cost of timber properties which carried a right to all future crops should be subject to any amortization for tax purposes, especially with the development of sustained yield operations. The degree of success in indefinitely sustaining the yield of a forest must be extremely varied, and a considerable time elapses before realization of future crops occurs. Accordingly, the amortization of cost seems best made in respect of the crop obtainable in the immediate future.

Timber Limits or Rights. Timber limits or rights can take a multitude of forms, varying from a right to cut specific trees out of a given area, to complete ownership of the land and its timber.

The general approach under the present tax legislation is to permit the forestry operator to claim a deduction for the cost of his timber rights as the timber is cut, calculated on a production basis 17/. Although this is commonly referred to as a depletion allowance, it is an amortization of cost and is therefore unlike the depletion allowance granted to oil and mining operations, which is based on a percentage of profits. An amortization of costs, rather than a deduction of a percentage of profits, produces a better measurement of business income. Furthermore, relating the amortization to the production is a more accurate way of matching the cost against resulting revenue. Any attempt at amortization on the basis of the time period of the limit or right would be futile because of their extreme variability in form, though not necessarily in substance.

Under section 1101(3) of the Regulations, each timber limit or right is to be treated as a separate class. In practice, however, companies often group different limits together and base their amortization on the group of limits, and this practice is accepted by the tax authorities. Schedule C of the Regulations requires that the cost subject to amortization should not include the residual value of the property, that is, the value after the merchantable timber has been removed. In practice, however, such a value is seldom assigned, and the complete cost of the limit or right may be written off even though a residual value exists. Thus, there is considerable divergence between practice and the law. If the allowance is to be calculated on a production basis as set out in the legislation, the provisions either would have to be much more complicated so that they would be precise, or would have to be set out briefly in broad terms. Because the amortization of the cost of timber limits or rights is usually a relatively minor part of the costs of large, integrated forestry operators, the latter approach is probably the better.

Another approach would be to bring the allowance for the cost of timber limits more into line with the capital cost allowance system generally by placing all costs in a class subject to a diminishing balance rate of amortization. Advantages of this system would include the allowance of a cost regardless of the actual production from specific limits, and the recognition of a continuing value where the rights to future crops exist. For the large forestry operators it might be possible to find a rate which would correspond to their usual experience. For a small forestry operator it would be difficult to find a rate which would be generous enough and, accordingly, some option to claim on a production basis would have to be given.

In view of these considerations we recommend that, for the measurement of business income from a forestry operation for tax purposes, the cost of a timber limit or right should continue to be amortized on a basis related to production, but in broader terms than at present. Provisions regarding residual value of the timber limit should be retained and enforced, although, for reasons explained below, this distinction would be of less importance if our recommendations relating to the disposal of timber properties were adopted. Survey and other costs incurred in acquiring a timber limit or right should be added to the cost of the timber limit or right and not, as at the present time, be written off on the basis of one tenth a year. In addition, during the operation of a timber limit, the taxpayer may have to do additional surveys, or he may have to incur costs in making unsuccessful applications for other timber rights, neither of which may be allowed under the present legislation. Our proposals to deal with "nothings" would take care of the latter items.

Woods Assets. A taxpayer may construct in the woods such assets as roads, bridges or camp buildings, which will be of no further use to him once the merchantable timber has been removed. Under the present legislation, the taxpayer has an option to write off the cost of such assets on the diminishing

balance basis at an annual rate of 30 per cent or on a production basis 18/. In general, the diminishing balance basis appears to be preferred. Mechanical equipment used in the woods is eligible to be written off at the rate of 30 per cent on the diminishing balance basis. These allowances appear to be operating satisfactorily, and we have no specific recommendations to make concerning them.

Carrying Charges. Generally speaking, carrying charges are those recurring costs of owning property which bear little direct relation to the use of the property or to changes in its value. They are important to the owners of privately owned timber limits, for, while it can be said that they do not specifically add value to the property, these costs are, because of the long maturing period of timber, essential costs to the owner if the increase in the value of the timber is to accrue to him. Furthermore, such costs can be more important than the original cost of the timber limit if a long period of time is involved.

Under the present tax legislation the carrying charges on timber limits or rights are usually allowed as operating expenses, although occasionally disallowance has occurred on the basis that carrying charges on inoperative properties are either not for the purpose of earning income or are outlays of a capital nature. As we shall see in the section below concerning disposal of timber properties, the exemption of capital gains makes the treatment of these carrying charges very important under the present legislation.

The proper matching of carrying charges against realized income is an almost impossible task, and any attempt to defer them as costs of earning income in future years could be frustrated by fire, disease and changing conditions. Although the results of a forestry operation over a long period of time are more predictable than, say, the results of exploring for minerals or oil, or of the building up of goodwill by an ordinary business corporation, the same general treatment appears appropriate. We therefore recommend that the tax legislation clearly allow carrying charges on timber limits and rights

as a current expense, although the taxpayer should be permitted to capitalize them if he so elected. Therefore, these expenses would not be lost as a deduction merely because of the long period of time involved before the resulting revenue is realized.

Reforestation. In Canada, the renewing of timber resources occurs mainly through the natural processes of nature. In some areas, however, and with certain types of trees, these natural processes are not adequate, and artificial reforestation is carried out at considerable cost.

The general tax treatment is to permit reforestation costs as a current expense if they are intended to replace the previous stock of timber, but to disallow any portion which would tend to increase the previous potential.

With increasing development of forest management policies, the treatment of reforestation costs as a maintenance item has a semblance of reasonableness. However, we have already concluded that the best approach to the matching of costs and revenue in the forest industry would be to look to the immediate crop of timber only. In this light, reforestation is theoretically a cost of developing an asset beyond the immediate future and should be deferred to the future. However, if reforestation is a required condition in removal of the present crop, and does not carry with it any rights for future cutting, its cost is reasonably related to the present. The immediate allowance of such costs may also be justified on other grounds. These would include the time gap between the costs and the resulting revenue, the achievement of equity between those timber owners whose reforestation occurs by natural processes and those who must adopt artificial means, and the general economic desirability of encouraging conservation. In view of these considerations, we recommend that it be made clear that the cost of reforestation would be allowed as a current expense. An exception might be made in the case of trees grown for sale as Christmas trees, where the period of time involved is much shorter.

Proceeds from Disposal of
Timber Limits or Rights

Under the present tax treatment, the first question to be settled is whether a disposal represents realization of a capital asset or a transaction in the ordinary course of trade. If it is the latter, the profit is fully taxable, whereas the former is taxable only to the extent that the proceeds may be considered to represent recaptured capital cost allowances 19/.

Where a taxpayer has taken all the timber of commercial value to him from a timber limit and claimed the entire cost, it is still possible that proceeds from a sale of the property may be considered to represent a recovery of capital cost allowance even though the specific property for which the allowance was claimed no longer exists.

The satisfactory application of the recapture rules depends on an allocation being made between the merchantable timber, the remaining timber, and the remaining value of the land and mineral rights, etc. This is an extremely difficult thing to do, as evidenced by the fact that residual value of timber properties is seldom recorded in practice.

It is anomalous that, although the gain on disposal of a timber limit may be treated as a non-taxable capital receipt, the carrying charges incurred in developing the limit could well have been allowed against other income in earlier years. Furthermore, the exemption of a gain on a block disposal of a timber limit encourages taxpayers to sell out for a tax-exempt gain rather than to operate for taxable gains. While there is little evidence that this has affected the actions of large forestry operators, it has probably influenced the actions of small ones.

The adoption of the comprehensive tax base we propose would require that all proceeds on disposal of a timber limit would be taken into account for tax purposes. The difficulties referred to above in dealing with the proceeds would disappear. Of course, an allocation among the elements of a

timber limit would still be needed in establishing the timing of deductions for the purchaser. There would be no problem in deciding whether certain expenses would be allowed or not.

Provincial Logging Taxes

Until recently, provincial taxes on logging income were deductible in the computation of income in a manner similar to the deduction given for provincial taxes on mining income 20/. For 1962 and subsequently, however, the allowance was changed to a tax credit. The lesser of two thirds of the provincial logging tax or 6-2/3 per cent of the taxpayer's logging income in the province is permitted as a deduction against federal income tax, 21/ and one third of the provincial logging tax is permitted as a deduction against provincial tax in Ontario and Quebec, and 18 per cent of the provincial logging tax against provincial tax in British Columbia.

For the same reasons given in Chapter 23 concerning provincial mining taxes, we recommend that provincial logging taxes should be treated as an expense and that no federal tax credit should be allowed.

Concessions to the Industry

The risk to which the industry is exposed arises mainly from the time factor in producing mature timber. For tax purposes, compensation for this feature may be found in early allowance of costs and the generous treatment we recommend in respect of carrying charges and reforestation costs, proposals that will have the incidental effect of benefiting the taxpayers in this industry and encouraging preservation of this natural resource. A further form of encouragement of privately owned timber limits and rights could be achieved by adopting a diminishing balance basis of capital cost allowance which could be claimed regardless of production. However, we do not believe that such a concession is warranted.

Revenue Effects

The recommendations concerning the write-off of costs would tend to defer revenue slightly. On the other hand, the taxation of all gains from disposal of timber properties would increase revenue slightly, although the effects would be sporadic. On balance, the effect on revenue would be relatively minor.

CONSTRUCTION

The construction industry has some characteristics that raise special problems of taxation. The most troublesome characteristic is the length of time that it may take to complete a single unit of production, for example, a bridge, a dam, or a large building. Many projects last more than a year and they do not fit easily into the pattern of taxing annual profits. Thus, it is relevant to consider how much reliance should be placed on accounting practices in computing income.

Measurement of Income

Contracts in the construction industry can be divided into four classes:

1. Fixed-total-price contracts, under which the contractor agrees to perform specified work for a fixed sum.

2. Fixed-unit-price contracts where the price is fixed by reference to units of work done, for example, so much per yard of asphalt laid.

3. Cost-plus contracts where the contractor is entitled to cost plus a fee related to costs.

4. Fixed-fee contracts where he is entitled to cost plus a fee of a fixed amount.

In fixed-total-price and fixed-fee contracts the progress billings are based on the contractor's estimate, usually approved by the architect or supervising

engineer, of the proportion of the total work done. These progress billings are seldom paid in full because, under provincial laws and often under the contract itself, between 10 per cent and 20 per cent of the amount billed is held back by the owner until the project is completed. Completion is signified by the architect's or engineer's acceptance of the project, and the hold-backs are then paid over to the contractor.

There are two generally accepted methods of accounting for income from construction contracts. The first is the "completed contract" method, under which no profits are recorded from a contract until it is completed or substantially completed. The other is the "percentage of completion" method, under which a proportion of the estimated total profit from a contract is taken up periodically according to the contract's stage of completion. The ratio of costs incurred by the end of a period to total estimated costs is generally considered to be the best measure of the degree of completion. The ratio of progress billings to the total contract price is not usually considered to be a suitable measure, because progress billings may be based on optimistic estimates of the degree of completion and may have been rendered in the hope of accelerating the cash flow from the contract.

The completed contract method is most appropriate for fixed-total-price contracts when major uncertainties or hazards make it impossible to estimate the financial outcome with any reasonable certainty until a large part of the work has been done. On the other hand, the percentage of completion method is appropriate when a minimum profit is assured, as in a fixed-fee or cost-plus contract. Under a fixed-unit-price contract, there may be some uncertainty as to the proportion of total profit while the project is in progress, because the average cost per unit over the whole contract may vary with the total number of units, which is still unknown, or the direct costs of each unit may vary by the nature of the work, even though the price per unit is fixed. However, the percentage of completion method would usually be followed. The major factor which makes the completed contract method the

more suitable is a high degree of uncertainty as to the final profit in a contract, and this is most evident in the fixed-total-price contract.

Present Tax Treatment

For several years prior to 1960 the Department of National Revenue used an arbitrary time basis for permitting certain fixed-total-price contracts to be reported on the completed contract basis. The procedure adopted by the Department was to require the percentage of completion method for cost-plus, fixed-fee and fixed-unit-price contracts and those fixed-total-price contracts lasting at least two years; and to accept, at the taxpayer's option, either the completed contract or the percentage of completion method for fixed-total-price contracts lasting less than two years. Thus, the only circumstances in which the completed contract method was accepted for tax purposes was for fixed-total-price contracts lasting less than two years. The tests for the suitability of the completed contract method were therefore the type of contract and the length of the contract, rather than the degree of uncertainty in its outcome.

While the fixed-total-price contract is the most suitable for the completed contract method, the length of a contract is not necessarily a measure of its risk, and therefore the distinction used for tax purposes did not fully accord with accounting and business concepts. Nevertheless, it appeared to work well and many contractors adopted the assessing procedure to record profits in their accounts. The main complaint was that assessors were unduly reluctant to accept anything other than the profit originally budgeted on a contract as the basis for the percentage of completion method, and taxpayers urged that the completed contract method should also be permitted for fixed-unit-price contracts lasting two years or more. From the Department's point of view, an objection to the unlimited use of the completed contract method was that the completion of short-term contracts was sometimes artificially delayed.

From about 1960 on, business and taxation calculations of contract profits began to diverge widely as a result of two cases—M.N.R. v. John Colford Contracting Co. Ltd. 22/ and Wilson and Wilson Ltd. v. M.N.R. 23/. In the Colford case the Supreme Court affirmed the finding of the Exchequer Court that hold-backs were not income until the contractor became entitled to receive them, which was usually not until the supervising engineer or architect approved the completed project. In the Wilson and Wilson case the Exchequer Court concluded that the completed contract method was not acceptable for income tax purposes, and that the proper measurement of income was to be based on the amount of progress billings made to the end of the year less the contract costs incurred to the end of the year, including the cost of materials delivered to the job site. While it was also suggested that section 85B required the gross amount of progress billings to be included in income, this part of the judgment was effectively reversed by the decision of the Supreme Court in the Colford case. The combined result of the two judgments, which is often referred to as "the legal basis" of contract accounting, is that, when a contract is in progress at the end of a fiscal period, the income to that date is the difference between progress billings then rendered, net of hold-backs, and all job costs then incurred. A taxpayer may now choose to compute his taxable income on the legal basis or according to the two-year rule, because the Department still accepts the latter method. From the contractor's point of view, the legal basis is usually more advantageous than the two-year rule because, at a mid-point in a contract, costs incurred, including materials delivered to the job site, often exceed progress billings net of hold-backs. The legal basis, because it does not require hold-backs to be included until the project has been accepted, is almost always better for the contractor than the percentage of completion method. The legal basis usually defers the tax liability longer than any usually accepted accounting method, and thereby improves the taxpayer's cash flow.

Using progress billings rendered to determine the contract profit at a mid-point is not a method that the industry has ever considered suitable for business purposes, because it can result in a substantial overstatement of the interim profit.

Appraisal

Because we would like to see a close correlation between business and taxation concepts of income, we consider the present situation in the construction industry to be unsatisfactory. We have stated that wherever possible income should be measured and taxed as it accrues. Accounting methods have been developed in the construction industry to record income as earned, and we believe that, as a means of determining contractors' taxable income, normal accounting methods would be preferable to the legal basis which has been developed. Unfortunately, for purposes of a tax system, the degree of risk in a contract, which is the logical factor for deciding whether to use the completed contract or the percentage of completion method, is not one which can be used because it is so difficult to determine. Discussions between the Department and taxpayers as to the risk on particular contracts could only be frustrating to both sides. If the method followed in a taxpayer's accounts were to be applied for tax purposes, the completed contract method would likely come more widely into use, to the detriment of both the tax revenue and accounting practices.

Some more workable, even though arbitrary, method must be found. The two-year rule which was administered fairly successfully in the past is one such solution. We can suggest another and, we think, a better one. At the taxpayer's option, consistently exercised, no profit would be taken up on any fixed-total-price contract until the costs directly applicable to the contract (excluding any allocations of administrative overhead) exceeded 35 per cent of the contract price, excluding extras. We suggest direct costs and contract price as the elements of the formula because they are less open to argument than other bases of measurement, such as total costs incurred

and total estimated costs. Almost one half of the work would have been done by this point, and thenceforward sufficient information would usually be available to make a reasonable estimate of the contract profit or loss. Once direct contract costs exceeded 35 per cent of the contract price, the percentage-of-completion method would be used. The percentage-of-completion method should be required for the other three types of contract regardless of the stage of completion. The nature of the percentage-of-completion method to be used should be prescribed by regulation, and should be based on the proportion of costs incurred rather than on billings rendered. Estimates of profits would, of course, include the amount of any hold-backs. The Regulations should also provide for a reasonable increase in estimated costs due to problems which were known to exist at the year end, and for the full deduction of an estimated loss on a contract as soon as costs exceeded the 35 per cent mark.

It seems to us that an arbitrary rule such as this would work more equitably among various contractors than the two-year rule which tends to favour the contractor dealing principally in short-term contracts. It would also remove any tax advantage from delaying the completion of a contract, and would eliminate the disputes that now arise as to whether a contract is completed. With the recognition of estimated costs of completion and full deduction of losses at an early stage in the contract, the two-year carry-back of losses we recommend elsewhere should be quite adequate for the construction industry. By setting out the rules in the Regulations, the present legal basis and the accounting principles in this area would be overridden to give a more satisfactory result for tax purposes.

GENERAL INSURANCE

For the purposes of this discussion, the term general insurance includes all classes of insurance other than life insurance. In broad terms, all general insurance written falls within the classifications of automobile, casualty, and fire. The general insurance business in Canada is carried on

by Canadian-controlled joint stock and mutual companies, foreign-controlled companies, and branches of foreign companies. These foreign companies are also joint stock and mutual.

The main tax considerations relate to provisions for policy claims (commonly referred to as "reserves"), mutual insurance, and the treatment of foreign companies operating in Canada.

Provision for Policy Claims

General insurance is intended to cover losses that might occur as a result of injury or damage to persons or property, and the "reserves" are the amounts set aside to meet these losses. The obligation of the insurer to pay claims is based on unpredictable events and therefore determining the appropriate provision for policy claims is not easy. The risk insured against is generally uniform throughout the term of the policy, usually from one to three years. It is therefore unlike the risk under certain types of life insurance policies where the contingency insured against will inevitably occur, and the chances of occurrence increase with the length of the policy term.

The provisions allowed for tax purposes in section 85B(5) of the Act and section 1400 of the Regulations are the unexpired portions of the premiums calculated on a time basis, plus certain other policy reserves required to be included in the annual statement filed with the Superintendent of Insurance, or, if the corporation is not required to submit financial statements to the Superintendent, the provincial authority under whose jurisdiction the corporation was incorporated. These other policy reserves are linked to specific groups of policies and do not include any general contingency reserves. Their purpose is to cover peculiar risks under guarantee and nuclear insurance, and to provide some reserve for group accident and sickness policies which, because they are generally written on a monthly basis, require little or no reserve under ordinary calculations.

Representations were made to us suggesting that an additional deduction should be allowed for tax purposes equal to the 15 per cent excess of allowable assets over liabilities as required under section 103 of the Canadian and British Insurance Companies Act 24/. It was also suggested that a deduction equal to 25 per cent of the yearly reserve for claims be permitted to cover catastrophic and abnormal events.

The general provision for estimated losses involves relating revenue to the year in which it is earned. This provision should be reduced by an estimate of agents' commissions paid in respect of the unearned premiums that have been written off as expense. Reasonable provisions should be allowed against losses which have occurred in the taxation year but for which final settlement is delayed. However, no provision should be permitted for occurrences which have not taken place, because to do so would be to anticipate possible future events. Accordingly, neither the additional specific policy reserves required in statements filed with the Superintendent of Insurance, nor the additional contingent reserves on which we received representations, should be accepted for tax purposes. Although these are intended to help ensure the solvency of the companies, it is not the function of the tax system to regulate the industry. It may also be noted that, if taxes should be overpaid because of an over-estimate of income in the early years of certain policies, they would be recoverable under the two-year carry-back of losses. However, one type of special reserve is related to events that have taken place in the year but have not given rise to claims as at the year end. Thus, specific provisions for guarantee insurance should be allowed, to the extent that they are based on an estimate of losses that occurred during the year.

Mutual General Insurance

Basically, mutual general insurance companies are owned by the policyholders and have various methods of raising working capital, setting premium rates, and paying policy dividends. One type of mutual organization, whose

operations are similar to those of a stock company, is called a cash mutual. Some cash mutuals charge single cash premiums for their policies, sometimes called non-assessable policies. The policyholders of large cash mutuals can become increasingly separated from the management in the same way as shareholders of large and widely held joint stock companies.

Another type of mutual is known as a premium note mutual. These organizations issue what is known as an assessable policy by taking a note for the premium based on the estimated cost of the insurance. Assessments are levied against the notes for cash to carry the overhead and other expenses and losses. Many mutual insurance companies started business as premium note mutuals, but recently they have tended to charge premiums in the same way as joint stock companies by the issue of non-assessable policies.

The remaining incorporated mutuals charge premiums which can range from a close estimate of the cost of the insurance to an amount considerably exceeding the estimated cost. Some of the organizations return almost all the excess to policyholders in the form of policy dividends, while others retain substantial amounts of the excess premiums as reserves. In the latter group the excess premium charge is often called a deposit premium. Factory mutuals that usually underwrite certain heavy risks in the manufacturing industry operate on the deposit premium basis.

Prior to 1947, mutual insurers were exempt from income tax under section 4(g) of the Income War Tax Act, while joint stock insurers were taxable under the general law. Pursuant to the recommendations of the 1945 Royal Commission on Co-operatives, the specific exemption for mutual insurance companies was repealed in 1947. In 1953, however, it was held by the Supreme Court of Canada that a mutual fire insurance company was not carrying on business for profit and therefore was not liable to tax on its income 25/. Section 68A was enacted in 1954 and imposed a tax on non-life mutual insurers.

Mutual insurance corporations receiving premiums wholly from the insurance of churches, schools, or other charitable organizations are exempted

from tax by section 62(1)(j) of the Income Tax Act. The 1945 Royal Commission also recommended that exemption from tax be granted to insurers which derived 50 per cent of their gross premiums from the insurance of farm and fishing property, and in 1954 section 62(1)(s) was introduced to this effect.

Our aim in the taxation of all mutual organizations is to tax the economic gain arising from the mutual operation. However, as is already obvious from the description of mutual general insurance, it is difficult to measure the gain in this field.

In principle, the economic gain to a member is the amount he saves on insurance premiums by insuring through a mutual instead of through a joint stock company. However, as in the case of life insurance premiums, it is difficult to determine just what the market rate is because there is such a variety of policies and risks. In our discussion of mutual life insurance companies in Chapter 20 we discuss the matter of pricing out, and the question of the extent to which policy dividends represent refunds of excess premiums. Our conclusion is that there should be no attempt to apportion policy dividends into the respective elements, and that such dividends should be deductible to the insurer and should be included in full in the income of the recipient. This treatment is similar to that recommended for other mutual organizations, for example, co-operatives. We accept that some pricing out will take place, but there is no feasible way of alleviating the problem, other than adopting a procedure for imputing income. (See Chapter 20.) However, in the general insurance field, a substantial proportion of the insurance written by mutual companies is issued to businesses which are entitled to deduct the premiums. In these cases pricing out is immaterial, because it would have no net effect on the income of the insured.

As far as the business income of the insurer is concerned, it should be determined in the same way as for other general insurance companies and should be taxed in full. In this regard, the exemptions granted to certain mutual

general insurance organizations are an unwarranted departure from equitable taxation, and we recommend that they should be repealed.

Foreign Companies

Under the present legislation, the business income of foreign insurance companies is calculated on the same basis as that applicable to Canadian companies, but in practice there are the following important exceptions: investment income is not included in taxable income, and no deduction is allowed for head office expenses incurred outside Canada.

At one time a deduction was allowed for head office expense, but apparently it proved difficult to arrive at some reasonable method of preventing excessive claims, and efforts were made to devise a system of taxation which would avoid the necessity of attempting to verify head office expenses, or to devise a formula for a maximum allowance. The idea of effecting a partial offset to the disallowance of head office expenses by eliminating investment income seemed to offer certain advantages. It met the problem at hand and removed what might in some circumstances be regarded as a disincentive to a foreign company to maintain assets in Canada.

This method of taxing foreign companies transacting general insurance business in Canada departs from our concept of equitable taxation. The exemption of investment income may provide some incentive for retention of assets in Canada but, in many cases, tax in respect of this income is payable in the foreign jurisdiction, so that the incentive may not be effective. We admit that there can be problems in determining reasonable allowances for foreign head office expense. However, as in the case of other businesses, no claim should be allowed except to the extent it can be shown to be reasonable. The foreign head office might be required to supply information regarding its world-wide operations to support the reasonableness of the portion of expenses charged to Canadian operations.

Therefore, we recommend that the business income from the Canadian operations of foreign general insurance companies should be determined in the same way as for Canadian companies, so that the investment income from assets required to be on deposit for the business would be included in the computation of profit, and a reasonable portion of head office expenses would be deducted.

Investment income from assets held in excess of those reasonably required for the Canadian business should be treated in the same manner as Canadian investment income of non-residents in general.

Part VIII of the Regulations provides for a reduction in the normal withholding taxes in the case of foreign companies registered with the Department of Insurance. In broad terms, the normal taxes are reduced by the proportion which Canadian liabilities are of Canadian assets. Canadian liabilities are defined to include double the amount of policy reserves as a "cushion" 26/. In view of the exemption of investment income of the business, which was granted in practice, this formula was probably designed as a method of confining the withholding tax to investment income which is not part of the income of the business. Because of our recommendation that investment income arising in the operations should be included in business income, the definition of Canadian liabilities for the purposes of the reduction in withholding tax should include only 100 per cent, and not 200 per cent, of policy reserves. This would increase the amount of investment income which would be subject to withholding tax and would reduce the amount of investment income which would be taxed as business income at the 50 per cent rate applicable to corporate income generally.

Foreign general insurance companies are exempt from the additional 15 per cent tax on the after-tax income of a branch operation imposed by section 110B of the Income Tax Act. We see no reason why Canadian branches in this line of business should receive special treatment and we therefore recommend that the exemption be repealed.

We should mention two other special features in the taxation of foreign companies. First, policies reinsured with companies not registered or licensed to transact insurance business in Canada are ignored. This usually means higher tax to the companies carrying on business in Canada, because they are required to pay tax as if they had retained the profits that normally would accrue to the company that accepts the reinsurance. However, it avoids the problem of verifying the profits or losses on reinsurance of Canadian risks ceded by a foreign head office to other foreign companies, and is probably the only practical approach under the circumstances of the business 27/.

Second, marine insurance transacted in Canada is not taken into account in computing the taxable income of a foreign company. The reason for this may be that taxation of profits of marine insurance in Canada would cause the insurance to be written at the other end of the voyage. This does not appear to be a sufficient reason for excluding the profits from such business from income, and we recommend that they should be taxable.

CONCLUSIONS AND RECOMMENDATIONS

FARMING AND FISHING

1. Income from farming should be reported on the "accrual" rather than the "cash" basis except in the case of an individual whose principal source of income is farming and whose gross revenue from farming is less than a specified sum, say, $10,000.

2. The use of the "basic herd" principle in the farming industry should be discontinued except where the farmer is permitted to continue on the cash basis, and the special regulation concerning the valuation of the livestock should be repealed.

3. The present administrative treatment of farm home expenses is unduly favourable to the taxpayer and should be altered.

4. The present specific restriction on the deduction of losses from hobby farming should be replaced by a general provision designed to prohibit the deduction from other income of losses incurred (after the first three loss years) by any business which consistently operated at a loss.

5. In view of the general averaging provisions recommended in this Report, the specific averaging provisions now applicable to farmers and fishermen would cease to be necessary.

6. The cost of depreciable assets used in farming and fishing should be amortized in accordance with the diminishing balance method of capital cost allowance which applies to all other types of business.

7. Profits made on the disposal of farm property should be taxable, subject to the lifetime exemption of $25,000.

8. Sale of farming or fishing property to the taxpayer's child should be deemed to be at the fair market value. If the sale price was less than fair market value, the difference would be treated as a gift.

FORESTRY

9. The cost of timber properties should continue to be amortized on a production basis, but technical changes in the current Regulations appear desirable.

10. Carrying charges and reforestation costs should be deductible as incurred. The taxpayer should have the option of capitalizing carrying charges.

11. Any gain realized on disposal of timber properties should be included in income in the same manner as gains on disposal of other types of property.

12. Provincial logging taxes should be deductible in computing income as an expense, and should not be claimed as a tax credit from federal tax otherwise payable.

CONSTRUCTION

13. There should be an arbitrary rule in the Regulations prescribing the basis for reporting profits from contracts in progress at a year end. The suggested rule is that all contracts should be reported on a percentage-of-completion basis except that, in the case of fixed-total-price contracts, percentage-of-completion reporting should not be required until direct costs have exceeded 35 per cent of the contract price, excluding extras. The percentage-of-completion formula would be based on the proportion of total costs to date to total estimated costs and would provide for reasonable adjustments in estimated costs based on known factors, and for full deduction of any estimated losses on fixed-total-price contracts as soon as direct costs exceeded 35 per cent of the contract price, excluding extras.

GENERAL INSURANCE

14. The deduction of premiums applicable to the unexpired portion of policies should be continued, but the current allowance of certain policy reserves should be discontinued and reserves for contingencies should not be permitted.

15. General insurance companies should continue to be permitted to deduct policy dividends in computing income. The exemption of certain mutual general insurance companies from tax should be discontinued.

16. The business income of Canadian branches of foreign general insurance companies should be determined in the same manner as that of Canadian general insurance companies (with certain minor exceptions).

17. Canadian branches of foreign general insurance companies should be subject to the special 15 per cent tax on branch profits under section 110B of <u>the Income Tax Act</u>.

REFERENCES

1/ Section 85F.

2/ Section 42.

3/ Section 13.

4/ Part XVII.

5/ Canada Gazette, Information Bulletin No. 3, Part I, January 20, 1951.

6/ Section 12(1)(a).

7/ Section 12(1)(h).

8/ The general problem of distinguishing between activities conducted for personal and for business reasons is discussed in Chapter 22.

9/ Section 13.

10/ Department of National Revenue, Taxation Statistics, 1963, Ottawa: Queen's Printer, 1963, Section II, Table 3, shows that in 1961 individual taxpayers in occupation categories other than farming or fishing (where the individual farming and fishing losses exceeded the farming and fishing gains) filing tax returns claimed farming or fishing losses in an amount of at least $7,771,000. In addition, those filing non-taxable returns showed farming or fishing losses in an amount of at least $7,662,000. Because the figures quoted are the result of netting the losses and gains of all taxpayers in each category, the total farming and fishing losses actually claimed would have exceeded these amounts.

11/ Section 42.

12/ Regulations, Part XVII.

13/ Section 20(4).

14/ Section 17(7).

15/ At the end of 1963, the market value of farm inventories was $3 billion, of which about $1 billion was in grain and $2 billion in livestock. (This information was supplied to us directly by the Dominion Bureau of Statistics from unpublished sources.) The cost value is not known and could not be estimated with reasonable accuracy, but presumably would have been in the order of $1 billion to $2 billion, of which only a minor portion would be reported as inventory for tax purposes. In addition, most of the livestock inventory reported for tax purposes would be in basic herds, the proceeds from which would be tax-exempt.

16/ In 1961, the income tax revenue from individuals engaged in farming full time was almost $27 million, and for corporations in the farming business was $1.6 million. Individuals, other than those in the farming category, reporting taxable income claimed farm losses in the amount of at least $7.7 million. See supra, reference 10 for an explanation of this amount.

17/ Regulations, section 1100(1)(e) and Schedule C.

18/ Regulations, section 1100(1)(f); Schedule B, Class 10(1), and Schedule D, Class 15.

19/ Even if a disposal represents realization of a capital asset, the entire proceeds may be taxable under section 6(1)(j) of the Income Tax Act, if they are dependent upon subsequent production or use from the property.

20/ Section 11(1)(p).

21/ Section 41A.

22/ [1960] Ex. C.R. 433. An appeal to the Supreme Court of Canada from this decision was dismissed from the bench without written reasons, [1962] S.C.R. viii.

23/ [1960] Ex. C.R. 205.

24/ R.S.C. 1952, Chapter 31. This section requires that, at all times, a company maintain allowable assets to a value of at least 15 per cent in excess of the total unearned premiums, matured claims, and other liabilities of every kind.

25/ Stanley Mutual Insurance Company v. M.N.R., [1953] 1 S.C.R. 442.

26/ In lieu of the amount of such liabilities, an amount may be claimed on the basis of deposit requirements, if it is larger.

27/ The non-Canadian operations of these companies are not required to be reported to the Superintendent of Insurance, and the chief Canadian agent of the company may have no knowledge of the reinsurance of Canadian risks by his principal.

PART D
INTERNATIONAL

CHAPTER 26

INTERNATIONAL ASPECTS OF INCOME TAXATION

A major objective that we have sought in our proposals for the domestic tax system has been tax neutrality. A neutral tax system would contribute most to the efficient allocation of resources, and hence to the greatest output of the goods and services Canadians want, and is also a prerequisite of an equitable tax system.

It will be evident by now that the economic and administrative realities of the practical world have forced us to accept compromises with true neutrality and equity in our domestic tax proposals. In our proposals for the taxation of international income we have had to make even greater concessions since here the administrative and economic problems appear in a more acute form. Not only are the problems of valuation and enforcement more difficult in the international area, but market imperfections are likely to be more important. Hence, purposeful deviation from tax neutrality under certain circumstances may become a necessity. In addition to the extreme complexity of the subject, the controversy that surrounds many of its fundamental principles and the lack of guiding evidence by which to settle those controversies militate against the adoption of simple, generally accepted solutions. In this area more is left to opinion and judgment, both because little is known with certainty of the consequences of adopting alternative policies, and because there are substantial differences of opinion as to the relative importance to be attached to the competing objectives. In the international sphere perfect tax neutrality is neither administratively feasible nor necessarily economically desirable.

The subject is therefore a challenging one and one which Canada of all countries can least afford to ignore. Canada's heavy stake in foreign trade and investment gives this country a particular interest in well-ordered international tax arrangements. Fortunately a good deal of progress has been made toward some standards of conduct for international tax behaviour

by negotiation and agreement. Over the last half-century the leading trading nations, under the auspices of world organizations, have developed a few basic ground rules that eliminate the grosser inequities and economic dislocations that would otherwise arise. While these rules fall far short of the ideals of neutrality and equity, their embodiment in national taxing statutes and in international treaties gives some order and certainty where chaos could otherwise rule. The value of these arrangements has also increased with the more extensive use of income taxes by both developed and developing countries as the major source of their revenue. The direct use of income tax provisions by many countries for the achievement of domestic economic objectives, and the heightened sophistication of taxpayers in arranging their affairs to minimize their tax liabilities, will add further to the need for international tax arrangements in the future.

MAJOR ISSUES

While the subject bristles with complexities and controversies, the larger issues in international taxation are surprisingly few. Substantially they are:

1. The treatment to be accorded income of non-residents at the time it is earned in Canada.

2. The treatment to be accorded certain forms of income of non-residents at the time it is withdrawn from Canada.

3. The treatment to be accorded foreign income of residents of Canada at the time it is earned outside Canada.

4. The treatment to be accorded foreign income of residents of Canada at the time it is received in Canada.

The practical questions to be settled are even fewer, since custom and the international tax treaties have already disposed of many of the issues that might have arisen under these headings.

1. For the foreign income of residents, two questions arise:

   a) To what extent should such income be taxed as earned abroad?

   b) What form of recognition should be given to the fact that the country of source of such income will have levied a tax on it?

2. For the Canadian income of non-residents, the main question is the level of withholding tax that should apply on the withdrawal of certain forms of payments from Canada.

In seeking to apply our standards of equity and neutrality to these problems we have proceeded on the basis of certain assumptions which should be stated here:

1. The treatment of foreign income of Canadian residents should include some recognition of foreign taxes levied on that income.

2. Foreign income of Canadian residents should also be taxed under the comprehensive tax base in accordance with procedures which minimize tax deferment and the use of tax havens, which are countries through which income can be channelled at little or no tax cost.

3. The benefits of integration of personal and corporation taxes should be restricted to domestic shareholders. We have adopted this position primarily because a similar alleviation of the tax on dividend distributions to non-residents would result in a cost to the Canadian treasury which would largely accrue to the benefit of foreign treasuries. This is admittedly a form of discrimination. However, we have assumed that this discrimination in favour of residents would not have adverse effects on foreign confidence, nor should it bring about retaliation as the tax position of the vast majority of non-residents would not be worsened relative to their present position except to the extent that non-residents would become worse off because of the removal of specific industry and corporation incentives, an impact that would apply equally to some residents.

4. We should strive for tax arrangements which maintain and, if possible, increase the net economic benefit that Canada derives from capital movements across its borders, consistent with our treaty obligations and the normal standards of international taxation. This implies that tax provisions that would permanently impede capital movements in either direction should be avoided. We do not review in this chapter the full discussion of the international economic issues covered in Chapter 5. In particular, the net benefits that might be secured by increasing foreign portfolio investment in Canada and reducing foreign direct investment correspondingly, are not dealt with further; nor is the question of Canada's dependence on a net capital inflow reopened. However, we take for granted that those who would eliminate the net capital inflow into Canada are not seeking to eliminate gross capital movements between Canada and the rest of the world. Capital movements may be impeded during the adjustment period following the introduction of our integration proposals, but it is not put forward as a measure intended to produce a permanent effect of this kind.

5. The net economic benefit that would result from higher taxes on dividend income going to non-residents would be too small and uncertain to warrant the risk in raising such taxes. An increase would probably provoke retaliation from foreign governments, particularly since the present level of Canadian corporation and withholding tax on dividends is close to, or in some cases even exceeds, the level of tax credit granted by the country of residence of the foreign investor. Where the tax on other forms of income going to non-residents is not subject to this constraint we have proposed an increase.

The domestic tax system which we propose as a means of more completely realizing Canada's economic and social objectives is radically different from the existing Canadian system and is unlike the systems in effect in other countries. Our most important task in this chapter is to develop tax provisions that would allow the adoption of a new domestic system without adversely affecting our economic ties with the rest of the world. This involves working out the technical problems resulting from the taxation of the income flows across the Canadian border. It also requires the development of tax provisions that maintain, and preferably increase, the net economic benefit that Canada derives from foreign investment in Canada and from the investment by Canadians outside of Canada, consistent with our treaty obligations and with the normal standards of international taxation.

The second task is to develop tax provisions that treat Canadians with foreign source income equitably relative to other Canadians. Thus, not only must all foreign source income be brought into the comprehensive tax base and be subjected to progressive rates of income tax, but it must be brought in under procedures that minimize tax deferment. In addition, it is necessary to eliminate the serious loopholes existing in the present system that allow some Canadian residents to avoid paying full tax on their income by the utilization of companies in tax-haven countries.

At the present time the rates of tax imposed on the Canadian source income of non-residents vary with the nature of the payment. Some payments (e.g., dividends) are subject to substantial Canadian tax, others to low rates of tax, and still others are not taxed at all. These disparities place an undue significance on the form of the payment, thus encouraging the adoption of procedures that lessen Canadian tax collections. Reducing these disparities is the third general task with which this chapter is concerned.

PRINCIPAL PROPOSALS

Our principal proposals deal with the form of tax credit to be granted to Canadians in respect of their foreign income, the manner in which such income should be taxed in Canada and the rate of withholding tax to be applied to the income of non-residents originating in Canada. These proposals are discussed in detail later in this chapter but are summarized here for convenience:

1. The present exemption from tax of certain foreign dividends received by a resident corporation which is provided by section 28(1)(d) should be withdrawn. Dividends received from foreign direct investment should be grossed-up at an arbitrary rate of 30 per cent and a foreign tax credit of the same amount allowed. If the dividend was received by a resident individual, then the applicable Canadian tax on the grossed-up amount would be payable at the time of receipt. However, if the dividend was received by a resident corporation, no tax would be payable until the income was in turn distributed or allocated, at which time a withholding tax of 20 per cent of the grossed-up amount should be collected so that the resident shareholders would be entitled to a tax credit of 50 per cent of the grossed-up distribution (the original 30 per cent foreign tax credit plus the additional 20 per cent withheld).

2. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents:

    a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or

    b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

3. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If the foreign income taxes paid on this current income (including those paid by a non-resident corporation) were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income was immediately subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was subsequently subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax paid on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect that it be taxed as portfolio investment income (i.e., income from an investment other than a direct investment) with credit only for withholding taxes paid.

4. For the purpose of these computations, foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement) with certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed, and we will suggest an additional modification that should mean that computations would rarely be necessary for most income derived from the United States and the United Kingdom.

5. Canadian portfolio investors (investors who were not direct investors) should be given an option:

   a) to be taxed on the same basis as direct investors as described above; or

   b) to be taxed as at present with a credit only for withholding taxes paid.

6. The basic withholding tax on most payments to non-residents other than dividends should be increased from 15 per cent to 30 per cent. This withholding tax should be applied to gifts and bequests, income from employment in Canada and the income portion of payments from pension plans, in addition to interest, royalties, etc. This 30 per cent rate might be lowered for some specific types of payments (e.g., the present exemption for certain interest payments to tax-exempt entities) and reduced by treaty for certain payments to specified countries.

7. A withholding tax of up to 10 per cent should be imposed on payments for services that were deducted in the computation of business or property income and were not already subject to a withholding tax. These services might well be rendered outside Canada but the benefit from them would be obtained in Canada. This withholding tax should not apply to amounts paid in reimbursement of expenses.

8. In certain specific cases non-residents should be entitled to elect to be taxed as residents of Canada, reporting their world income from all sources and deducting foreign tax credits on the present basis for foreign taxes paid on income from foreign sources. This election should be available in the following cases:

   a) where a Canadian resident became non-resident and elected to be taxed as a Canadian resident for each year after the change of residence; or

   b) where a non-resident received certain kinds of income from Canada, including gifts, inheritances, the income portion of pension and annuity payments and employment income.

The implementation of these recommendations would, we believe, confer the following important advantages:

1. Substitution of a 30 per cent gross-up and credit for the section 28(1)(d) exemption:

    a) Removal of the exemption under section 28(1)(d) for foreign dividends received by a Canadian corporation from a company in which it held at least a 25 per cent interest would eliminate a major loophole in the present tax system through which some Canadians have in effect avoided the payment of their full Canadian tax on Canadian source income which has been diverted through companies in tax havens.

    b) The use of an arbitrary flat-rate tax credit would reduce, to a great extent, the significance of the tax mix of the source country. Thus, the balance between income taxes and withholding taxes would be unimportant and the extent to which other taxes (e.g., sales taxes) were utilized in the foreign jurisdiction would be less important.

    c) Once it was decided that a broad exclusion like section 28(1)(d) was not appropriate, the use of an arbitrary rate would simplify the computations and remove much of the uncertainty. Both of these advantages would be particularly important to ensure that Canadian corporations were not discouraged from establishing foreign operations. Although the procedure would require the measurement of the underlying foreign source income from most countries, this would not generally apply to income derived from the United States or the United Kingdom (from which over three quarters of the foreign source dividends of Canadians are derived). This special treatment could perhaps later be extended to other countries after experience has been gained in administering the provisions. In any case, the adjustments required for the other countries, although arbitrary, would be relatively simple. Because property gains would be taxed in full to Canadians on realization, full Canadian tax would be

collected in the long run. Arbitrary procedures to compute the annual tax liability therefore would not be as inequitable as they might otherwise be.

d) A flat-rate gross-up and credit would result in the progressive rate schedule being applied to foreign source direct investment income.

e) Adoption of a rate of 30 per cent for the gross-up and credit would have two advantages: Canada would derive some (albeit small) net revenue from foreign source dividends, and most shareholders in Canadian companies with foreign direct investments would pay no more Canadian tax on foreign source dividends than they do at present.

f) The gross-up rate could be adjusted from time to time to meet particular circumstances. A reduction in the rate might be necessary if over time the expected before-tax rates of return on corporate assets in Canada declined following the adoption of the integration proposal.

2. Requiring payment of income tax on foreign direct investment income at a rate of at least 30 per cent:

a) A requirement that taxes of at least 30 per cent be paid each year to either the foreign jurisdiction or to Canada as the foreign income was accrued would reduce the tax deferment and the minimization advantages provided directly or indirectly by tax havens.

b) The recommended procedure would reduce the importance, from a taxation viewpoint, of the form of organization adopted for carrying on foreign operations. It would also largely eliminate any effect Canadian taxes might have on the decision to retain or remit funds from the foreign operation.

3. Increasing the level and scope of withholding taxes:

   a) The increase in the standard withholding tax (on most payments other than dividends) to 30 per cent would narrow the gap between the rates of tax imposed on different types of return on capital. It would reduce the attractiveness of some of the present methods employed to reduce the Canadian tax liabilities on income derived from this country and would thereby increase Canadian tax revenues.

   b) The application of a withholding tax to another form of remittance from Canada, namely, service fees, would ensure that at least some tax revenue was collected on income from services enjoyed in Canada and performed by non-residents who were not physically present in Canada when the services were rendered.

The balance of the chapter is devoted to further consideration of the concept of neutrality and its implications for our specific tax proposals, to an outline of the actual tax systems in effect in Canada, the United States and the United Kingdom, and to separate consideration of the tax issues and of our proposals for Canada as a country receiving income from abroad and as a country which is the source of income going abroad. We then examine some of the administrative aspects of international taxation and finally we review the nature and effect of the tax treaties.

NEUTRALITY AS AN INTERNATIONAL CONCEPT

Because of its key position in our consideration of the various proposals for international taxation, we will explore at some length in the following paragraphs the meaning of "neutrality" as a guiding concept for these proposals.

To achieve complete international tax neutrality, the tax systems of all nations would have to be so harmonized that each individual would be indifferent, from a tax point of view, about his citizenship, his country of

residence, the location of his property, the location of his business and the location of his job. This would require that all nations:

1. Provide the same public goods, services and transfer payments to those residing or carrying on business in the country 1/.

2. Finance the provision of these public goods, services and transfer payments with the same kinds of taxes levied at the same rates.

3. Avoid, shift and adjust to the same taxes to the same degree and at the same time.

4. Tax each individual on his world income, defined in a uniform manner, at the same rates as those at which he would be taxed if he derived all of his income from his country of residence; these rates would have to be the same whatever his country of residence 2/.

In deciding where to work, where to invest and where to carry on business, tax considerations could be ignored because the ratio of the expected after-tax rate of return to the expected before-tax rate of return would be a constant for each individual. If these conditions were realized, expected before-tax rates of return in different countries would not be distorted, relative to one another, as a result of differences in national tax systems.

The conditions cited above would be extremely difficult to realize even with the best of intentions on the part of all nations. If all nations were to provide the same kinds and levels of public goods to their residents with the same bases and tax rates, per capita national incomes would have to be approximately the same. This condition is unlikely to be met in the foreseeable future—if ever. Differences in national preferences between public and private goods and between different kinds of public goods will continue to prevail. National resource endowments, national market sizes and national mixes of industries are so diverse it is difficult to imagine that

avoidance, shifting and adjustments to taxes will ever be the same in all nations.

In Chapter 19 we discuss how before-tax rates of return on productive assets change in response to changes in taxation. It is useful to briefly review that discussion here.

Unless all taxes are avoided or shifted to exactly the same extent and at the same speed, the imposition of what purports to be a completely neutral tax will nevertheless change the allocation of resources among alternative projects. To illustrate what is involved, assume that in a world with no taxes there are two kinds of projects, types A and B. Each kind of project is expected to yield a before-tax rate of return of 10 per cent. Suppose that a tax of 50 per cent is imposed on the net gains from both kinds of projects and that there is no avoidance. If the tax on the income from type A projects is fully shifted, the before-tax income is doubled and the after-tax income is unchanged; if the tax on type B projects is not shifted the before-tax income is unchanged but the after-tax income is cut in half. Investment in type A projects would be much more attractive than that in type B projects. However, over time the higher rate of return would lead to increased investment in type A projects which would increase the output of the goods produced by these projects. The increased supply of these goods would gradually force their prices down. As a result the before- and after-tax rates of return on investments in type A projects would decline. Conversely, the reduced investment in type B projects over time would result in an increase in the before- and after-tax rates of return from type B projects. Under simplifying assumptions, the before-tax rates of return on both kinds of projects would, in time, converge and once again be equal.

These adjustments of before-tax rates of return to changes in taxes must be taken into account in analyzing international income taxes. Resources would not necessarily be allocated efficiently throughout the world if expected before-tax rates of return were the same in all countries.

The expected before-tax rates of return may differ between two countries not because capital was more productive in one than the other but because the same taxes imposed at the same time in both countries were not shifted to the same extent and the investment adjustment process had not yet reduced the return in the tax-shifting country or raised it in the non-shifting country.

Because of market imperfections, differences in expected before-tax rates of return among alternative projects are an imperfect indication of the net benefit that would be derived from different investments within a nation. The interpretation of international differences in expected before-tax rates of return is even more difficult because, in addition to the "normal" market imperfections, nations not only have different tax systems but have purposely adopted substantial barriers to the flow of goods, capital and labour. Because of the distorting effects of these differences in tax structure and of countervailing national economic barriers we cannot presume that the allocation of resources on a world basis in accordance with these expected before-tax rates of return would lead to greater world output.

Realization of the fourth condition would be particularly difficult in a world consisting of debtor and creditor nations. If the types and amounts of each nation's foreign source income were equal to the types and amounts of its domestic source income flowing to (or attributable to) non-residents, the problem would be straightforward. All nations could agree to tax income on a destination basis. Whatever their views about the "proper" allocation of revenues between origin and destination countries, if they all adopted the same policy there would be neither revenue gain nor revenue loss, for the additional revenues obtained from fully taxing the foreign source income of residents would just be offset by the revenues forgone by not taxing the domestic source income of non-residents. But because some nations are net debtors and some net creditors such an easy solution is not possible. To tax solely on a destination basis would mean that debtor

nations would be worse off; to tax solely on a source basis would mean that creditor nations would be worse off.

Thus, even if all nations had identical tax systems, there would be an inescapable conflict between net debtor and net creditor nations as to the "proper" division of revenues between source and destination countries. Debtors would continue to argue that the major share of the revenue should go to the country in which the income originated; creditors would continue to argue that the major share of the revenue should go to the country of residence of the recipient of the income.

From this discussion of the conditions necessary for the realization of international tax neutrality, it is obvious that such an objective is unattainable within the foreseeable future. But what is even more important, international tax neutrality may not even be desirable while other international economic barriers exist (such as tariffs, immigration laws, foreign investment guidelines, and foreign exchange controls). All of these artificial barriers to the free movement of goods, capital and labour among nations distort the international allocation of resources just as much or more than unneutral tax systems. It would only make sense to strive to develop an internationally neutral tax system if by doing so a more efficient international allocation of resources throughout the world would be achieved. As long as these non-tax barriers between nations prevailed, an improvement in the international allocation of resources would probably require national tax systems that deviated from neutrality to compensate for the other barriers.

Once this point is reached we are forced to admit that it is impossible to make any general statements about how international income flows should be taxed by any particular country if the purpose is to achieve an efficient allocation of world resources. It depends entirely upon the particular circumstances. While compensating deviations from a neutral tax system are theoretically possible, it would be extremely difficult in the present state

of knowledge to determine the form and magnitude they should take.

This is a depressing conclusion because we know that, in the absence of all barriers to the movement of labour, capital and goods between nations (or with offsetting adjustments if they could not be removed), world output would be greater. The nations that would gain from the removal of barriers to international mobility could more than compensate the nations that would lose, and still be better off. Although it would be naive to expect that this idyllic state of the world will soon be attained, men of good will must not lose sight of this long-run objective. If they cannot further its realization, they can at least refrain from creating obstacles to its ultimate attainment.

We do not advocate the unilateral removal of all international barriers by Canada. It is impossible to say, except in terms of the particular facts, whether or not a unilateral reduction in a particular barrier would be in our long-run interest. Some Canadian barriers are probably necessary to compensate for the barriers erected in other countries. If other nations raise international economic barriers Canada may have no alternative but to raise countervailing barriers. We need this retaliatory capability. However, we should try to avoid situations that would require retaliation by Canada or would lead to retaliation by other countries against Canada.

We do not doubt that Canada should pursue its self-interest. But we believe that a world with lower national barriers to the movement of labour, goods and capital would be in Canada's long-run self-interest. We can hardly expect reductions in international barriers to be made by others if we are busy erecting our own.

PRESENT TREATMENT OF INTERNATIONAL INCOME IN THE UNITED STATES, THE UNITED KINGDOM AND CANADA

As a background to our specific proposals it is useful to set forth a brief composite picture of the present Canadian, United States and United

Kingdom systems for taxing international income. The present Canadian system is described in greater detail after discussion of the composite picture. To facilitate the following description, we will discuss international income under three general headings:

1. Business Income
2. Property Income
3. Employment Income

Business Income

Business income arises from the carrying on of a direct business activity in one country by a resident of another country. One of the principal instances is operations carried on by a corporation through a branch; another is activities of a business character carried on directly by an individual or sole proprietor.

Business income under our comprehensive tax base would, of course, include gains on property disposed of by a non-resident in the course of carrying on a business in Canada.

Property Income

Property income is composed mainly of the normal forms of return from the investment of capital, the lending of money or the rental or licensing of property in another country, where the activity is not of such a character as to constitute the carrying on of a business. These forms of income (dividends, interest, rents and royalties) are usually subject, on distribution to a resident of another country, to "withholding" taxes levied by the source country. In some instances, withholding tax is also applied to other types of income.

The concept of "property income" as applied to international taxation would not include gains realized on the disposition of property. Such gains would usually be taxed only if realized by residents of the source country.

We have already pointed out, however, that under the comprehensive tax base property gains would be included in income where they formed part of business income, whether earned by a resident or a non-resident.

In the case of dividends received, a distinction is usually made in the country of destination, for purposes of levying its own taxes, between dividends from a company in the source country in which the holding is sufficiently large to constitute "direct investment" and those from a company in which the holding falls below the test for direct investment and is treated as "portfolio investment". Normally the distinction has no relevance in the country of source in the application of its taxes on payments leaving the country.

The test for direct investment, although not referred to as such, is established by statute; in the United States ownership of 10 per cent or more of the voting shares is required and in Canada more than 25 per cent. It is of interest to note that even ownership of all the shares of a company in another country constitutes investment in that other country and not the carrying on of a business. For purposes of taxation in the foreign country, the wholly owned subsidiary would normally be regarded as a resident of that country and subject to the usual taxes in that country. The fact of foreign ownership would be of relevance only for the application of additional taxes on dividends leaving the country.

Employment Income

This classification is almost self-explanatory. It consists of income received under a contract of employment where the employment is performed by a resident of another country.

Set out below is a skeletal description of the way in which these various types of income are taxed (subject, of course, to a number of exceptions) under the Canadian, United States and United Kingdom systems. Because the United States tax treatment of foreign source income is of particular

interest in view of our recommendations, a more detailed description of its procedures is contained in Appendix L to this Volume.

Taxation in the Country of Source

1. Business Income. Income tax is imposed at full domestic rates on "business income" earned in a country of source by a non-resident.

2. Property Income. Tax is levied at a flat rate on investment income (interest, dividends, rents and royalties) paid to a non-resident.

3. Employment Income. Domestic graduated rates of tax, or a flat-rate tax in lieu thereof, is normally applied to the income of a non-resident, such as salaries and wages, for personal services performed by the non-resident in the country of source.

Taxation in the Country of Destination

1. Business Income. Business income earned by direct business activity in a source country is included in income in the destination country, whether remitted or not. It is grossed-up to include direct taxes paid in the country of source and a credit is allowed for those taxes against the taxes in the country of destination, but not exceeding the tax on the same income in the country of destination.

2. Property Income. Property income from a source country (other than dividend income from direct investment) is included when received, and is grossed-up to include withholding or similar taxes paid to the country of source. A credit is allowed for those taxes against the taxes in the country of destination, but not exceeding the tax on the same income in the country of destination.

3. Employment Income. Is accorded the same treatment as property income.

For dividends the above statement for property income applies to "portfolio investment", but a different treatment is provided for "direct investment".

Where either the United States or the United Kingdom is the country of destination of a dividend from direct investment, that dividend is grossed-up to include direct taxes levied in the country of source on the corporate income from which that dividend was declared as well as the withholding tax on the dividend, and a credit is allowed up to the amount of the domestic income tax on the same income for the underlying corporation income tax of the source country and for any withholding tax levied by the source country on the dividend when paid. In the United States, interest income received from the direct investment is aggregated with the dividend income in computing the foreign tax credit. Where Canada is the country of destination of such a dividend, a different treatment applies. The dividend, when received by a Canadian corporation, is free of any further Canadian corporation income tax.

Some notable modifications of this general description, usually based on the pursuit of an economic objective, may be found in all three countries. In the United States they include the Western Hemisphere Trade Corporation, the 1962 tax-haven legislation against the "controlled foreign corporation", the exceptions therefrom granted to the Export Trade Corporation and to companies operating in under-developed countries, and the Interest Equalization Tax. In the United Kingdom a comparable instance was the Overseas Trade Corporation which, under the 1965 Finance Act, was abolished as of April 6, 1966. A Canadian example is the treatment of foreign business corporations.

PRESENT TREATMENT OF INTERNATIONAL INCOME IN CANADA

The following very brief outline of the Canadian method of taxation brings the subject closer to our direct lines of inquiry.

Residents

The basic Canadian test of liability for income tax is residence, as contrasted with citizenship or domicile or combinations of these three factors which are used in some other countries. A Canadian resident, whether an individual, corporation, or any other form of entity, is taxable in Canada at Canadian rates on total world income. The general concept of residence is not a clear one. For most purposes, an individual who lives more or less continuously in Canada as part of the routine of his life is a resident. For a corporation, the general rule is that it is resident at the place where it is managed and controlled. This rule has been modified and extended in recent years by statute, so that in most cases a corporation is now resident in Canada if it is incorporated in Canada, regardless of where its management and control is located.

Business Income. Where a Canadian resident carries on business directly in a foreign country, as through a branch, the whole income is taxed in Canada as earned, and a credit is allowed for income taxes paid to the foreign country up to the amount of the Canadian income tax on the same income.

A special type of resident corporation—one whose assets and business operations are substantially outside Canada—is exempt from Canadian tax liability as a "foreign business corporation".

Property Income. Where a Canadian resident receives property income from abroad (dividends, interest, rents, royalties, etc.), that income is grossed-up to include any withholding taxes levied by the country of source and a credit for those taxes is allowed up to the amount of the Canadian income tax on the same income.

This treatment is modified where more than 25 per cent of the voting shares of a foreign company are owned by a Canadian corporation. In these circumstances, dividends from the foreign company are received by the Canadian corporation free of corporation income tax under section 28(1)(d) of the Income Tax Act.

Employment Income. A resident individual receiving employment income from a foreign source will include that income for Canadian tax purposes on a grossed-up basis and deduct from his income tax otherwise payable a credit for the foreign income taxes paid up to the amount of the Canadian income tax on the same income.

Non-Residents

Business Income. A non-resident carrying on business in Canada is taxed in the same way as a resident in respect of the earnings from that business activity, the main difference being that the income included in the computation of the rate of tax applicable is limited to the income earned in Canada. However, in the case of a business carried on in Canada through a branch of a foreign corporation, an additional tax of 15 per cent is imposed on a part of the profits of the branch remaining after payment of corporation income tax on those profits. A special deduction in respect of investment in fixed capital is allowed in calculating the income subject to this tax.

Property Income. Payments of property income by residents to non-residents of Canada are subject to withholding taxes as follows:

1. Dividends of a company owned to the extent of 25 per cent or more by Canadians (with a variation in this rule if the shares are listed on a stock exchange)—10 per cent; all other dividends—15 per cent.

2. Interest—15 per cent with certain exceptions, the most important being the exemption for interest payments on bonds issued after April 15, 1966, by the federal, provincial, and municipal governments, and for interest payments to organizations exempt from tax in their country (conditional on certificates of exemption being provided).

3. Rentals—15 per cent, but in the case of realty rentals a non-resident may elect to pay tax at the applicable Canadian tax rates after filing an income tax return of net Canadian rental income.

4. Royalties—copyright royalties are not subject to withholding tax; film and tape royalties—10 per cent; all other royalties—15 per cent. A recipient of timber royalties may elect to be taxed on his net Canadian income by filing a return as in the case of a recipient of real estate rentals.

5. Estate and trust income and patronage dividends—15 per cent.

A 15 per cent tax in lieu of any other tax (including the withholding tax on dividends and interest paid) is imposed on the income of a non-resident-owned investment corporation—a corporation substantially owned abroad whose income is substantially from investments.

Employment Income. A non-resident of Canada who has been employed in Canada must report his Canadian income and pay tax on that income at the usual graduated rates. An appropriate proportion of the Canadian concessions and allowances is granted as a deduction in determining taxable income.

The foregoing describes the main elements of the Canadian tax system for non-residents under the Income Tax Act. Modifications made by treaty have not been discussed.

TAXATION IN CANADA AS THE COUNTRY OF DESTINATION

Equity Considerations

Equity requires that all foreign source income, whether it results from working, investing or carrying on business abroad, be taxed to residents on the same basis as domestic source income. Under our proposal for the full taxation of property gains, this would mean that residents holding rights to or interests in property located outside of Canada would be taxed on the disposition of such rights or interests (including a disposition on death) or on the net gains deemed to have been realized on giving up Canadian residence.

Because income not brought into Canada must necessarily result in an increase in the value of the resident's interest in foreign property (ignoring foreign source income that the resident spends on personal consumption outside of Canada), all foreign source income would ultimately become subject to Canadian taxation. This would close what is now a substantial loophole in the tax system. Residents can now establish a foreign corporation to hold their income-earning assets in a country with low corporation taxes. The income can be retained in the foreign corporation and the resident can realize this income without Canadian tax by the sale of the shares in the foreign corporation.

Unfortunately the full taxation of property gains poses significant problems. If the property gains on rights to or interests in property located outside of Canada were brought into income only when realized, there would be a deferment problem. We have already demonstrated that the postponement of taxes can be about as advantageous as the avoidance or reduction of taxes. On the other hand, if such gains were taxed on an accrual basis, it would be difficult to determine the market value of property located in another jurisdiction.

Our proposal for the domestic tax system initially brings only realized property gains into income. We have also proposed that, unless the current earnings of Canadian intermediaries are brought into the income of shareholders and beneficiaries annually, such income should be subject to tax in the organization—usually at the top personal rate. This prevents the deferment of tax that would otherwise be possible if distributions were subject to additional personal tax. To place residents with interests in foreign corporations and trusts on the same basis as persons with domestic investments, the interest of Canadian residents in the income of these foreign organizations should also be taxed currently at the top personal rate. However, if these organizations did not make cash distributions, some Canadian shareholders or beneficiaries might

not have the cash available to pay the Canadian tax imposed in respect of the accrued income. In addition, there would be a number of administrative problems involved in the determination of the amounts to be taken into account each year.

These administrative questions would basically be concerned with determining what was the foreign source income for Canadian tax purposes, when the foreign income should be brought into account and what was the amount of the foreign tax credit that was to be deductible in determining the Canadian tax liability. Obviously business income for tax purposes in the source country need not be the same as business income for tax purposes in Canada—and in fact the differences in legislation are apt to result in substantial variations. A recomputation of the foreign source business income on the basis of Canadian rules could be an extremely complex procedure for the taxpayer, and yet, without such a recomputation, the amount included in the Canadian tax base would not properly reflect the Canadian rules for the determination of income. The question of timing also has administrative implications because it affects the determination of the amount of foreign source income and taxes that should be taken into consideration in each year.

Economic Considerations

There are economic as well as administrative questions that have to be considered in any attempt to attain neutrality in the taxation of the foreign source income of residents. The principal question is the extent to which Canada should give residents credit for the taxes paid to other governments on their foreign source income. At the one extreme, it can be argued that in so far as the Canadian government is concerned, the taxes paid to a foreign government by a Canadian-controlled foreign corporation are simply an expense of doing business abroad, and no credit should be given for foreign taxes (corporation or withholding taxes) against the resident's Canadian tax liabilities. This would mean that in deciding whether to invest in Canada or in another country that imposed income taxes,

the expected before-tax rate of return on a foreign project would have to be higher than the expected before-tax rate of return on a Canadian project.

At the other extreme, it can be argued that Canada should give full credit for foreign taxes paid against Canadian tax liabilities—even to the point of refunding foreign taxes if they exceeded the Canadian tax liability. If this were done, the Canadian investor would be completely indifferent to the taxes imposed by other countries. Other things being equal, projects with the same expected before-tax rates of return would be equally attractive wherever their location because they would all have the same expected after-tax rate of return to the Canadian resident.

For the reasons outlined in our discussion of international tax neutrality, we are convinced that it is impossible to say categorically what this foreign tax credit should be if Canada wished to achieve an efficient allocation of capital throughout the world. We simply do not know the extent to which the expected before-tax rates of return in different countries reflect the "true" return from capital. We are forced to fall back on pragmatic considerations.

Ignoring the implications of the adoption of our integration proposal, which will be discussed later, we reject the proposition that Canada should provide a full credit for foreign taxes (including the making of refunds if the foreign taxes paid exceeded the Canadian tax liability). We likewise reject the proposition that Canada should give no credit for foreign taxes. The granting of full credit with refunds is rejected because this would require Canada to rebate taxes it had never collected and would leave the Canadian treasury at the mercy of foreign treasuries. Full credit for foreign taxes up to the Canadian tax is rejected because we believe that every resident of Canada enjoys some public benefits and should bear some of the Canadian tax burden of providing these benefits and because the resident should be made aware that foreign investment imposes a revenue

loss on Canada. For, from a restricted point of view, if the before-tax return on a Canadian investment is greater than the after-foreign-tax return on a competing foreign investment, Canada "loses" the amount of the differential if the foreign investment is undertaken.

The net economic benefit that Canada derives from foreign investment by Canadians is uncertain. Some Canadian direct investment extends markets for Canadian goods, secures supplies, and improves Canadian technology. It is undoubtedly profitable to individual Canadians and economically advantageous to the nation. At the other extreme, some foreign portfolio investment is only profitable to individuals because Canada gives credit for the withholding taxes imposed by other governments, and presumably confers little if any net economic benefit on Canada. Unfortunately, there are no adequate measures of the net benefit from either.

Changes in the Canadian tax treatment of residents that would deter investment abroad are less likely to shake international investor confidence in Canada or lead to foreign retaliation than adverse changes in the tax treatment of non-residents who invest in Canada. However, we cannot be indifferent to the reactions of non-residents and foreign governments to changes in Canada's treatment of Canadians who invest abroad. If Canada deters its residents from investing abroad we are obviously in no position to complain when other nations seek to deter their residents from investing in Canada. Although the immediate net benefit to Canada of foreign investment by Canadians may be small (conceivably negative), if Canada adopts tax provisions that discourage foreign investment by Canadians and this results in foreign retaliation, Canada could lose more elsewhere than it would gain through the reduction of foreign investment by Canadians. How this net loss could come about can be readily explained.

Canada obtains a net economic benefit from most investment in Canada by non-residents. The revenues obtained from taxing the income earned by such investments are an important part of that benefit. The revenues that can

be raised by taxing foreign investment in Canada without deterring such foreign investment are dependent upon the credit that foreign governments give to their residents with respect to the taxes paid to Canada. If foreign governments gave lower or no credits for taxes paid to Canada, Canada would be forced to lower its taxes on the income of foreign investments in Canada to prevent a sharp drop in such investment 3/. This would reduce the net benefit we obtain from foreign investment in Canada.

We do not know whether foreign governments would remove or reduce their foreign tax credits if Canada refused to give Canadian residents credit for foreign taxes. But the gains from reducing foreign investment by Canadians would be small and uncertain even if there were no foreign retaliation, while the losses would be large and predictable if there were retaliation. Therefore, we reject the idea that Canada should seek to inhibit investment abroad by Canadians by withdrawing credits for foreign taxes paid on the income resulting from foreign investments by Canadians.

Specific Types of Income

It will be recalled that we are concerned with the tax treatment in Canada of three main types of income: business income, property income and employment income.

Property Income and Employment Income. A discussion of the treatment of property and employment income can be readily concluded since we propose no substantial changes in the present procedures, except for dividends which will be discussed in detail below.

Property income from abroad is now included in Canadian income grossed-up for any withholding tax imposed by a source country and with a credit allowed against the Canadian tax for such a foreign tax to an

amount not exceeding the Canadian tax on the foreign source income. We see no reason for departing from this procedure.

For employment income earned by Canadians abroad we propose continuation of existing procedures without change.

Direct Investment Income (Including Business Income). We bring income derived from direct investment in a foreign corporation and foreign business income together for the present discussion because their underlying similarity raises the same general issues. The conduct of business in a foreign country through a wholly or substantially owned subsidiary differs little, from an economic point of view, from direct operation through a branch, and the same general issues of taxation are involved. The singular difference for tax purposes under the present law is that interposition of the foreign corporation means that the Canadian company operating abroad through direct investment in a corporation includes as income only dividends actually received from that corporation, whereas the Canadian company operating directly through a branch is regarded as having earned and received the full profits of the branch each year and obtains credit for the foreign tax thereon. As we have seen, in the United States and the United Kingdom the same general procedure—the full gross-up and credit procedure—is used for both direct business activity and direct investment income. Canada, although ostensibly reaching much the same general objective by the two routes, has adopted different forms of treatment for branch income and dividends from direct investment. Branch income, as we have said, must be included in Canadian income grossed-up for the foreign income tax and recalculated to conform to Canadian rules for computing taxable business income. The Canadian tax is calculated on the foreign income so adjusted and a credit is allowed for the foreign tax paid, but not in an amount that exceeds the Canadian

tax. On the other hand, dividends derived from direct investment in a foreign corporation—at present where more than 25 per cent of the voting shares are owned—are exempt from Canadian corporation income tax on receipt in Canada. The only condition for this exemption is the required degree of ownership.

It is apparent that within the Canadian treatment of foreign source business income may be found the two classical extremes of allowance for foreign taxation. One provides for the full, accurate and precise measurement of the foreign income and tax liability, with a precisely computed credit against Canadian tax. The other grants an exemption from tax under conditions very easily met. The United States and the United Kingdom have followed the first method both for branch income and direct investment income, and no provision comparable to section 28(1)(d) of the Income Tax Act may be found in the tax system of either country. There are some examples of exemption of foreign dividends to be found in other countries, but Canada is virtually unique in its adoption of a provision as sweeping as section 28(1)(d). Its origins and effects are therefore of considerable interest.

The exemption contained in section 28(1)(d) appears to have had as its original purpose the achievement of an equitable and administratively simple alternative to the complexities of the gross-up and credit procedure. At the time of its introduction in 1949, the bulk of Canadian foreign source income originated in countries having corporation taxes as high as the Canadian, mainly the United States and the United Kingdom. The effect of this section was undoubtedly to provide directly for the virtual exemption of foreign source income from Canadian tax which was the end result of the complicated gross-up and tax credit procedure previously in force. Its origins in section 4(r) and subsections (2A) and (2B) of section 8 of the

Income War Tax Act are clearly discernible, and the fact that both of these sections were repealed in 1949 on the enactment of section 27(1)(d) (now section 28(1)(d)) supports the conclusion that, initially, the provision was looked on mainly as a device for administrative simplification. At first the ownership requirement was 50 per cent or more but in 1951, following the recommendation of the Advisory Committee on Overseas Investment, the ownership test was reduced to its present 25 per cent as a means of encouraging foreign investment by Canadians. It has since remained at that level.

One result of these provisions is that the Canadian taxpayer has enjoyed a much greater simplicity and ease of calculation for foreign income than his United States or United Kingdom counterparts. The tax minimization possibilities of the exemption privilege, in combination with the use of foreign tax havens, have not gone unnoticed. The provision can be used to reduce Canadian tax on income generated in Canada for the benefit of Canadians. By establishing companies in jurisdictions which impose little or no tax, Canadians can reduce their Canadian tax by engaging in a series of paper transactions which exploit the provisions of tax treaties in combination with section 28(1)(d).

There is also evidence that the provision has offered the possibility to use Canada itself as a tax haven for international business. Data compiled for us by the Taxation Division show that over a period of years a very substantial part of the dividends reported under this section has originated in jurisdictions imposing little or no tax, and that a very high proportion of these dividends has been received in Canada by holding companies not having a substantial Canadian economic interest but representing for the most part foreign ownership. Of a total of $1,500 million received by all Canadian corporations (including those that were owned by non-residents) in the five years from 1957 to 1961, only 10 per cent came from the United States and 4 per cent from the United Kingdom.

The defects of the present section 28(1)(d) are obvious, and we therefore recommend its repeal.

Full Gross-up and Credit

The most obvious alternative to the present Canadian treatment of income from direct investment (it is already in effect in Canada for direct business activity in a foreign country) is that employed by both the United States and the United Kingdom—the so-called "full gross-up and credit" method. We have recommended the full gross-up and credit method as the appropriate basis for the taxation of Canadian corporation income for residents. The logical counterpart would be to extend the same principle to the foreign direct investment earnings of Canadian corporations and individuals. The effect would undoubtedly be to produce a more exact calculation of the foreign tax credit and a more accurate allowance of that credit against the Canadian tax.

One serious disadvantage of the full gross-up and credit system in the international field is that it is far more complicated than the present Canadian method and would introduce a whole new range of administrative complexities for both taxpayers and tax authorities. In principle, it would require that the foreign corporate income being grossed-up be completely recalculated on the same basis as the Canadian, so that the taxable income, the tax to be credited and the tax credit limitations would be comparisons of like with like. Such adjustments are required now only in a relatively limited number of cases for direct business activity, mainly involving branches. But the extension of the full gross-up treatment to all foreign companies in which there was a Canadian direct investment would greatly multiply the number of companies affected. Also, consideration would have to be given to allowing a similar grossing-up procedure for the subsidiaries of the main foreign subsidiary (i.e., sub-subsidiaries) in order to carry the taxes of the sub-subsidiaries through the main subsidiary to the Canadian parent. (The United States law now provides for inclusion of only the

second level of foreign subsidiaries.) Furthermore, questions of the method for calculating the average rate of tax, the identification of years in which income was earned by the subsidiary and received by the parent and a host of other problems not now of significance would take on great importance for all Canadian companies having a direct investment in a foreign company.

The effect of the full gross-up and credit system is to bring up to the level of Canadian taxation the corporation income tax on business income earned anywhere in the world. While we do not in general favour the use of taxation for international competitive purposes, we are forced to recognize that in many new countries one of the few means available for granting economic incentives is taxation. To require that the tax on business income earned in those countries must ultimately be at least 50 per cent would completely frustrate, or "neutralize", any incentives extended by the new countries. Also, in these same countries indirect taxes are frequently a large element in the tax mix. These represent a burden on any business operating in a country of source which, in the present state of international taxation, is not taken into account in determining the tax credit in the country of destination. In bringing the ultimate corporation income tax burden up to a rate of 50 per cent, we would be disregarding the existence of these indirect taxes.

The recent experience in the United States with attempts to cope with similar problems is indicative of the complexities that can be encountered where the full gross-up and credit system is extended to overcome tax avoidance through foreign tax havens. As a measure to assist the balance-of-payments problem, President Kennedy recommended to the Congress in 1961 that foreign-earned corporate income be deemed to have been received and to be taxable in the United States as it accrued abroad. It was reasoned that if tax deferment were removed, United States companies would immediately bring home their foreign earnings. The proposal met with a storm of protest from United States industry and, after protracted hearings and Congressional

studies, a measure emerged directed not at tax deferment in general but at deferment of tax on certain forms of income accruing in tax-haven jurisdictions. Income of a "controlled foreign corporation" of a specified character (generally of a "passive" type, that is, not related to the conduct of an economic activity in the actual location of the foreign subsidiary) is deemed to be received by the United States shareholders owning 10 per cent or more of the voting shares of the corporation and is then taxable. Exceptions are made where certain minimum distributions are made by the controlled foreign corporation, where the controlled foreign corporation is operating in a less developed country or where it is a corporation devoted exclusively to export trade 4/.

We have considered this United States legislation as a possible model for Canadian action but have concluded that it is far too complex in its detailed application for our more limited goal. The role of the United States in the world economy is so crucial that a measure of this sort must meet a wide and conflicting variety of objectives, and in the process assume such complexity that its full ramifications are not even yet fully apparent. Much of this complexity stems from the fact that the objective of the legislation was to bring into taxation, at full United States rates, accumulating foreign source income, the natural result of applying the full gross-up and credit mechanism. The conditions under which this onerous treatment should apply and the nature of exemptions from it, therefore, had to be defined with great care. We have concluded that our much less ambitious objectives could be achieved by adopting somewhat more arbitrary but simpler methods. We have designed our proposal with this in mind.

The remaining objective we have sought, a degree of integration of foreign corporation taxes with Canadian personal income tax, could as well be achieved under the gross-up and credit method as under any other by adopting some arbitrary and simplified procedures. However, we have already concluded that full integration of foreign corporation taxes with the

Canadian personal income tax is not acceptable, as it would mean that the Canadian government would be required to make massive refunds to Canadian shareholders of taxes collected by other governments. This, then, is the primary reason for rejecting the use of the full gross-up and credit. We have therefore sought in our solution a degree of integration that is something less than would be achieved by the system of full gross-up and credit for foreign direct investment income.

Our Proposal

We have concluded that Canadian objectives can be met adequately by a solution somewhere between the full gross-up and credit at the one extreme and the exemption provided under the present section 28(1)(d) at the other. We are primarily concerned at this point with the position of companies having foreign subsidiaries which now qualify under section 28(1)(d). The future status of business activities carried on directly abroad through branches will be referred to later.

Foreign Direct Investment Income

Scope of application. We propose that the treatment outlined below should apply to a foreign direct investment. A foreign direct investment would be an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group held a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group held a 10 per cent or greater interest. This percentage is smaller than the 25 per cent now specified in section 28(1)(d), but would appear to be a reasonable dividing line between an investment which is not made for purposes of having a direct influence in the affairs of a company, and one which can carry with it some measure of control. However, because of other provisions discussed below, this artificial dividing line should not result in any inequity for a taxpayer who had less than a 10 per cent interest and, accordingly, was not

able to qualify for the 30 per cent gross-up and credit. In the case of an investment in a foreign company, the 10 per cent would only apply to direct shareholdings. Subsidiaries of a foreign company in which a direct investment was held should be included if an interest of 50 per cent or more was held by the foreign parent and by other shareholders who were not dealing at arm's length with that company.

Procedure. Where a direct investment was held, the following procedure would apply:

1. The income and tax liability would be computed (as described below) generally in accordance with the broad principles of the Canadian tax law.

2. In the case of a Canadian individual with a direct investment in a foreign property or business, his proportionate interest in the income earned in the foreign jurisdiction would be included in his income for Canadian tax purposes in the year it was earned, the net income after foreign tax being grossed-up to include the foreign taxes paid or deemed to be paid, not exceeding 30 per cent. Therefore, the applicable Canadian tax would become payable immediately and credit would be allowed for the foreign taxes paid or deemed to be paid up to the 30 per cent maximum.

3. In the case of a Canadian individual with a direct investment in a foreign company or with an investment in a Canadian company that itself had a direct investment in a foreign company, property or business, the procedure would be more complex:

   a) Where foreign taxes were paid or were deemed to have been paid at the rate of 30 per cent or more on the foreign source income so recalculated, generally no Canadian income tax should be payable until the foreign income was distributed to Canadian individuals. Thus, no Canadian tax should be payable by a Canadian

individual with a foreign direct investment company until he received a dividend. Similarly, in this case, no Canadian tax should be payable by a Canadian corporation with a foreign direct investment, either when dividends were received or when property or business income was earned. However, when such a Canadian corporation in turn distributed or allocated the foreign source income to its individual or corporate shareholders, or when the foreign dividends were received directly by a Canadian individual having a direct investment in the foreign company, the full rates of Canadian tax should apply to the grossed-up dividend, with a deduction of a deemed foreign tax credit at the 30 per cent rate. We recommend that where a Canadian company received the foreign income and subsequently made a distribution or allocation it should be required to withhold 20 per cent of the grossed-up amount distributed or allocated to residents in order to bring the total tax credit available to its Canadian shareholders up to the full 50 per cent 5/.

b) Where foreign income taxes were paid, or were deemed to have been paid, at a rate of less than 30 per cent, a Canadian investor (corporate or individual) having a direct investment in the foreign company should be required to pay a tax on his pro rata share of the grossed-up foreign income so recalculated sufficient to bring the total income taxes paid on such income up to 30 per cent. This would be the case whether or not the income was distributed or allocated to the Canadian investor. Thus, the Canadian tax would be the difference between 30 per cent of his pro rata share of the grossed-up income for Canadian tax purposes and his pro rata share of the actual foreign income taxes paid on this income. It might be provided that this computation would be based upon the average foreign taxes paid over a period of time, so that major differences in the tax liability between years would not distort

the overall tax position of the Canadian shareholder. If withholding taxes were imposed on a subsequent distribution by a foreign company in which the direct investment was held, a claim could be made for a refund of the special Canadian tax paid up to the amount of the tax withheld. Otherwise, a distribution would be treated in the same manner as is outlined under (a) above and 4 below.

4. When a Canadian direct investor, corporate or individual, received a dividend from the foreign corporation, the net amount received or earned (after any withholding tax deducted at source) should be grossed-up by an arbitrary 30 per cent for the deemed foreign income taxes paid. When property or business income is earned on a foreign direct investment it should be grossed-up at the lesser of the actual foreign income taxes paid or 30 per cent. In either case the grossed-up amount would be included in income and a credit would be allowed for the 30 per cent as foreign income taxes paid. Examples of this procedure are given in Table 26-1 below.

To recapitulate, the substance of our proposal is to require that income taxes (foreign and Canadian) of at least 30 per cent be paid on income from a foreign direct investment from year to year as it accrues. Other than the requirements of making whatever computation was necessary to determine whether income taxes of at least 30 per cent had been paid and of paying any Canadian tax liability that may be due as a result of such computation, there would be no further Canadian tax implications until the income from the direct investment operation was actually distributed by the resident corporate direct investor. Where a resident corporation received such income, there would be no tax consequences at the time of receipt, but only when it made a distribution or allocation to resident individuals. Thus, income would be taken into account in Canada only when received by individuals and the computation of the gross income and foreign tax credit would be relatively simple.

TABLE 26-1

AN EXAMPLE OF A TAX ARISING FROM A DIVIDEND RECEIVED BY A RESIDENT SHAREHOLDER OF A RESIDENT CORPORATION WITH INCOME DERIVED SOLELY FROM FOREIGN "DIRECT INVESTMENT", ASSUMING FULL DISTRIBUTION BY THE CORPORATIONS OF ALL EARNINGS AFTER TAXES

Under the Proposals in This Report

Net Foreign Dividends Received by Resident Parent Corporation		
Annual before-tax income of the foreign direct investment		$100.00
Foreign corporation tax at, say, 50 per cent		-50.00
		$ 50.00
Foreign withholding tax at, say, 15 per cent		-7.50
Dividend received by resident parent corporation		$ 42.50
After-tax Resident Corporate Income Distributed or Allocated to Resident Shareholders		
Resident parent corporation brings into income a/		$ 60.71
Foreign tax deemed to have been paid b/	$ 18.21	
Withholding tax payable on distribution to resident shareholders c/	12.14	$ 30.35
After-tax corporate income distributed or allocated to resident shareholders		$ 30.36
Resident Personal Tax and Rebate	25 per cent marginal rate	50 per cent marginal rate
Resident shareholder brings into income d/	$ 60.71	$ 60.71
Personal tax thereon	-$ 15.17	-$ 30.35
Corporation tax credit	+30.35	+30.35
Canadian tax rebate	$ 15.18	$ 0.00
Cash Position of Resident Shareholder	25 per cent marginal rate	50 per cent marginal rate
Cash dividend	$ 30.35	$ 30.35
Net resident tax rebate	15.18	0.00
Net cash	$ 45.53	$ 30.35

Under the Present Tax System

Net Foreign Dividends Received by Resident Parent Corporation		$ 42.50
After-tax Resident Corporate Income Distributed to Resident Shareholders		$ 42.50
Resident Personal Tax	25 per cent marginal rate	50 per cent marginal rate
Resident shareholder brings into income	$ 42.50	$ 42.50
Personal tax thereon	-$ 10.62	-$ 21.25
Dividend tax credit	8.50	8.50
Net tax paid	$ 2.12	$ 12.75
Cash Position of Resident Shareholder	25 per cent marginal rate	50 per cent marginal rate
Cash dividend	$ 42.50	$ 42.50
Net resident tax paid	2.12	12.75
Net cash	$ 40.38	$ 29.75

Notes:

a/ $\$60.71 = \dfrac{\$42.50}{100 - 30 \text{ per cent}}$ (i.e., $42.50 dividend received grossed-up at a rate of 30 per cent)

b/ $18.21 = 30 per cent of $60.71 (or $60.71 less $42.50)

c/ $12.14 = 20 per cent of $60.71

d/ $\$60.71 = \dfrac{\$30.36}{100 - 50 \text{ per cent}}$ (i.e., $30.36 dividend received grossed-up at a rate of 50 per cent)

Table 26-1 illustrates the basic gross-up and credit computations required under our proposal for a Canadian shareholder and a Canadian parent corporation of a foreign subsidiary and contrast them with the present system. It is assumed that the foreign subsidiary had before-tax income of $100 and that the balance remaining after tax was distributed in full right through to the individual Canadian shareholder.

Most Canadian individual shareholders who held an interest, either personally or through a Canadian corporation, in a foreign direct investment that was subject to foreign income taxes of at least 30 per cent would have their position improved by the use of an arbitrary 30 per cent gross-up procedure.

We pointed out earlier in this Report the importance of eliminating possibilities for tax deferment, and in our recommendations concerning taxation of domestic source income we suggested procedures to accomplish this objective. An extension of this approach to the foreign direct investment income of Canadians would be to impose an additional 20 per cent tax on a Canadian corporation having such income at the time it was earned in order to bring the total of the creditable foreign taxes and Canadian taxes on its portion of the foreign income up to 50 per cent. A Canadian individual having a foreign direct investment would include his portion of the income in his tax base at the time such income was earned. However, we do not recommend such a major step at the present time for a number of reasons. In the first place we have not recommended that capital gains be subject to tax on a full accrual basis and accordingly the taxation of foreign source income on this basis would be more severe than our recommendations for some types of domestic income. Secondly, if distributions were made by a foreign corporation to provide funds to pay the Canadian tax, this might result in liability for withholding tax in the foreign country which would further increase the taxes immediately payable. Accordingly, the imposition of the additional 20 per cent tax might adversely affect the competitive position in the foreign country of an enterprise having Canadian direct investors.

Thirdly, there may be circumstances in which a Canadian investor has a minority interest in a foreign corporation and is not in a position to obtain information as to the amount of the foreign income or is unable to obtain distributions with which to pay the additional Canadian tax, and special relief would presumably be necessary for these cases. Fourthly, we later recommend that the additional 20 per cent tax should not apply to that portion of the foreign direct investment income of a Canadian corporation which is distributed to non-resident shareholders, so that if this tax was imposed on an accrual basis special provisions would be required to exempt the income accruing for non-resident shareholders. While for these reasons we do not recommend the taxation of foreign direct investment income on a full accrual basis at this time, consideration might later be given to this possibility to prevent undue deferment of the tax liability. If this were done we would suggest that it should not apply to foreign direct investment income earned in the United Kingdom and the United States and possibly in other countries designated by regulation, so as to ensure that the above difficulties do not apply to most foreign direct investment income.

As a means of combating tax avoidance we examined the possibility of defining tax havens in order to apply special rules to income derived from those sources. Although we believe that such a definition is possible (perhaps by defining a genuine business operation), any test that essentially must rely on a business purpose rule would be difficult to administer. Since the purpose of rules relating to tax-haven companies would be to speed up the imposition of a tax that would eventually become payable on distribution or realization, it would be necessary to require that the full Canadian tax be paid on an accrual basis. We do not recommend the use of such a business purpose test or any other definition of a tax-haven operation at the present time. However, if the use of tax havens continued to increase despite the immediate imposition of tax up to a 30 per cent level and the full taxation of property gains, consideration should be given to the limited application of the full accrual procedure to income of tax-haven operations.

It should be noted that the general procedures we have proposed in Chapter 19 for the recording of adjustments to the cost basis of property would be equally suitable for recording the taxation of foreign source income on a full accrual basis if, for example, at some future time this was considered desirable in the case of tax-haven companies or foreign direct investment income generally (other than from listed countries). The cost basis of a foreign direct investment could be increased each year by the amount of income after foreign taxes which was earned in the foreign jurisdiction. Any dividends paid, up to the total amount of these increments in the cost basis, would then be considered a return of capital and would result in a reduction in the cost basis or, if they exceeded the cost basis, the excess would be included in income. The Canadian investor would be entitled to a refundable credit in respect of any withholding tax which was imposed by the foreign country at the time the dividend was paid. A procedure along these lines would necessitate a detailed annual computation of the foreign source income for Canadian tax purposes. However, the use of arbitrary rules along the lines already discussed would simplify these computations and should prevent the procedure from becoming unduly cumbersome.

Rate of Foreign Tax Credit for Foreign Direct Investment Income. The choice of the rate of gross-up and credit for foreign corporation taxes and withholding taxes paid by foreign corporations in which Canadians hold direct investments deserves a special comment. Assume, for the moment, that an investment of $1,000 in corporate assets yields before-tax income of $100 both in Canada and in the foreign jurisdiction. Assume a corporate rate of tax of 50 per cent in each country. If a Canadian resident forms a Canadian corporation that operates entirely in Canada and distributes all of its after-tax income, shareholders with marginal rates of 50 per cent now receive an annual after-tax return of $35. 6/ If, on the other hand, the Canadian corporation forms a foreign subsidiary, the $1,000 in corporate assets invested abroad returns to the Canadian shareholder of the Canadian corporation $29.75 after taxes, assuming the rates of foreign tax used in the calculation

above. In other words, the before-tax income on the corporate assets of a direct investment in the foreign country would have to be about 16 per cent greater than the return in Canada to be equally attractive to a Canadian shareholder.

Under our integration proposal, if there was no shifting or adjustment in the rate of investment in Canada, a Canadian resident taxed at a marginal rate of 50 per cent who owned shares in a Canadian corporation with Canadian source income would earn $50 7/ per $1,000 of corporate assets rather than $35 as at present. If the tax treatment of income from a foreign direct investment remained unchanged, the Canadian direct investor in the example cited earlier would have to earn a before-tax income on corporate assets that was about 68 per cent higher in the foreign country than in Canada to make the same after-tax return 8/. This percentage would vary, depending on the rates of foreign corporation taxes and withholding taxes. Under the proposal that we recommend (a gross-up and credit for foreign taxes at 30 per cent) the total tax liability on foreign direct investment would be slightly reduced for the 50 per cent shareholder in most circumstances. It would be more substantially reduced for most low income and middle income resident shareholders (as shown in Table 26-1). The after-tax return from the foreign direct investment would equal that received from a Canadian investment with the same before-tax income only if the total rate of foreign taxes was 30 per cent or less.

The adoption of the 30 per cent gross-up and credit for foreign corporation taxes would have the following consequences:

1. In most cases a Canadian resident with direct investments abroad would not be worse off with respect to dividends received from such investments.

2. Income from foreign direct investments in most cases would be taxed much less heavily to low income Canadian shareholders than at present.

3. The refunds to low income shareholders for foreign corporation taxes would be more than offset by the Canadian taxes collected from upper income shareholders.

4. There would be a reduction in Canadian revenues from foreign direct investment by Canadians, but there would be no net refund by Canada of taxes levied by foreign governments.

With a credit of less than 30 per cent for foreign corporation taxes, upper income shareholders of Canadian corporations with direct investments abroad would be worse off. With a higher credit, Canada would refund more through the foreign tax credit than would be collected on the same income at the progressive rates of Canadian tax. As a result, corporations competing against Canadian foreign subsidiaries in other countries would justifiably protest that Canadian foreign subsidiaries were being subsidized by the net rebates by Canada of foreign taxes paid.

The estimate that the before-tax return on corporate assets would have to be higher in a foreign country which imposed corporation and withholding taxes at rates totalling more than 30 per cent than in Canada (about 68 per cent higher in the example cited) to yield the same after-tax return to a Canadian shareholder was, as we said, predicated on the assumption that there would be no change in the before-tax rate of return on corporate assets in Canada as a result of integration. As we indicated in Chapter 19, we do not expect this assumption to hold.

There would be some reverse shifting under integration—that is to say, some portion of the reduction in the corporation tax would be passed on to consumers or suppliers or both—and, in addition, the improved cash position of corporations and the higher prices of Canadian shares should bring about a re-allocation of investment in Canada. We frankly admit that we have no precise estimates of the speed with which these adjustments would take place but we are confident that they would take place and that

they would, in time, reduce the before-tax rate of return on corporate assets in Canada.

It is important to recognize, therefore, that the immediate result of adopting our integration proposal would be to make Canadian investment in Canada much more attractive to Canadians from the standpoint of taxation than most foreign investment. However, the adjustment subsequent to integration would tend to reduce the before-tax rate of return on corporate assets in Canada, and because the before-tax rate of return on foreign corporate assets would not likely be affected by integration in Canada, the relative unattractiveness for Canadians of investing abroad would gradually be reduced.

The uncertainty as to the speed of the adjustment of the return on corporate assets following integration makes it extremely difficult to select the optimum rate of credit for foreign corporation taxes that should be adopted. If the adjustment were slow, a high rate of credit would be required if foreign investment by Canadians was not to be substantially reduced for a prolonged period. If the adjustment were rapid, a lower rate of credit would be acceptable.

The extent of the adjustment is also relevant in determining the rate of the credit. When the adjustments following integration had been completed, would the expected before-tax rate of return on corporate assets in Canada be equal to, greater than or less than those that now prevail? What would be the differential between these Canadian expected rates of return and those in other countries? Answers to these questions obviously would depend upon a multitude of factors, including national savings and investment rates, changes in attitudes toward risk and technological changes. Fortunately these difficult questions do not have to be answered because the credit does not have to be fixed in any ultimate sense.

If expected before-tax rates of return on Canadian corporate assets declined to the point where foreign investment became more attractive than

domestic investment, the 30 per cent credit could, of course, be reduced 9/. In any event, the extent to which foreign investment by Canadians should be encouraged or discouraged in the future would have to be judged in the context of the future needs of the economy and our international commitments at that time. The credit device is sufficiently flexible that we think it could be used to discourage or encourage foreign investment by Canadians as the occasion demanded.

Computation of Foreign Source Income for Canadian Tax Purposes. It will be recalled that a cardinal feature of our proposal is to require that income taxes of at least 30 per cent be paid on income from a foreign direct investment from year to year as it accrues. If foreign income taxes were less than 30 per cent of the foreign income, the difference would be paid to Canada as a special tax. In order to satisfy this requirement it would, of course, be necessary to compute the foreign income.

It is extremely important, we believe, that any procedure adopted for the taxation of foreign source income should be certain in its impact and relatively simple to administer. Complex tax provisions under which the exact tax implications are not known for some years after a transaction is completed are inequitable and a serious deterrent to international business.

We therefore recommend that the computation of foreign source income for Canadian tax purposes should not be based upon the full and detailed application of the Canadian legislation; with some exceptions, it should be the income as reported to the foreign tax authorities. However, certain general principles should be applied to foreign source income in the same way as to income earned in Canada, even if these principles were not part of the law of the foreign jurisdiction. For example, if all kinds of gains of Canadians were to be taxed and no type of income was to be exempt from tax, foreign source capital gains should also be taxed in full. Similarly, percentage depletion on mining and petroleum operations should be disallowed whether the income was derived from Canada or from a foreign jurisdiction.

Thus, the starting figure for the foreign source income subject to tax should be the income as reported to the foreign tax authority. But adjustments of a general nature should be made so that foreign source income would be defined in roughly the same way as Canadian source income. Alterations should not be made to put the timing of the income on exactly the same basis or to ensure that the allowance or disallowance of minor expenditures was similar. The depreciation or capital cost allowance permitted by the foreign jurisdiction should generally be accepted.

The required adjustments should be explicitly detailed in regulations to prevent uncertainty. These regulations would also specify which foreign taxes were to be treated as income taxes for purposes of the tax credit computation.

In some cases there would be no requirement to report income to a foreign tax authority, as, for example, where certain tax havens were used. In other cases the concept of income as computed for tax purposes in the foreign country would not be at all comparable to the Canadian concept. In these circumstances, it probably would be necessary to base the computation on the income as shown in audited financial statements, with adjustments to bring it into line with the concept used for Canadian tax purposes. In the absence of a reliable audited financial statement, it would be necessary to compute the income in detail in accordance with Canadian tax law.

To further simplify procedures, income derived from the United States or the United Kingdom (with perhaps other countries to be similarly designated subsequently) should be subject to virtually no adjustments for, generally, income from Canadian direct investment in these countries would be deemed to have been subjected to income taxes of at least 30 per cent. The only circumstances in which adjustments would have to be made would occur when the amount of the foreign source income as defined for foreign income tax purposes was substantially different from what it would have been for Canadian tax purposes because certain specified items of particular

significance under Canadian tax law had not been taken into account (e.g., capital gains, depletion and a few others). These adjustments should be required only when they exceeded a specified proportion of the income reported to the foreign tax authority for a period of three or five years. In such an event the procedure applicable for other countries should be followed. Because over three quarters of foreign direct investment income attributable to Canadian individuals is derived from these two countries, and because the exception would not often apply, well over one half the foreign direct investment income of Canadians would not be subject to adjustment.

Problems Arising from Lack of Control by Foreign Direct Investors. Because a foreign direct investment would be defined to include an interest of 10 per cent or more in a foreign corporation, which may be less than a controlling interest in the foreign corporation, it may happen that a Canadian resident having such an investment would be unable to obtain information from which to compute his tax liability. Where this was the case and the taxpayer made a declaration that he was unable to obtain access to the necessary corporate information, either by himself or in conjunction with other shareholders with whom he was not dealing at arm's length, he should be entitled to make an election that the investment be treated as a portfolio investment. This election should be possible only if the taxpayer had taken all reasonable steps to obtain the information, and it would not be available in any case in which he controlled the foreign corporation either alone or together with other shareholders with whom he was not dealing at arm's length.

It is also possible that a shareholder with a direct investment in a foreign corporation subject to a low rate of foreign income tax would not be able to obtain any distribution from the corporation with which to pay the special Canadian tax on the income earned by the corporation. If the corporation was in a jurisdiction which imposed income taxes at the rate of 30 per cent or higher, no Canadian income tax would then be payable on the income earned (until it was distributed by the Canadian corporate direct investor),

and there would not be any such difficulty. If the corporation was in a jurisdiction which imposed income taxes at a lower rate, the shareholder would be liable for a special tax. However, there would only be a "double" tax if the investor disposed of his foreign direct investment without having received the income on which he had paid the special tax. Relief could be provided by permitting a tax credit in these circumstances for the amount of the applicable special tax paid.

Taxes "In Lieu" of Income Tax. Industries in some taxing jurisdictions are subject to taxes other than income taxes. While we fully realize the complications involved in such a recommendation, we believe that with an increased reliance on the gross-up and credit procedure it would be essential to recognize any tax levied by another country that could reasonably be regarded in the circumstances as an alternative to an income tax. Such taxes may take the form, for example, of pay-roll taxes or natural resources taxes. We recognize that comparable taxes levied by the Canadian federal government or a provincial government in Canada would be treated as a charge on net profit; nevertheless, it might well be reasonable to deem such foreign taxes to be income taxes for purposes of computing the foreign tax credit. We do not consider that this treatment should be extended to sales taxes or import duties.

Canada does not now allow credit for income taxes imposed by a political subdivision of a foreign country. From the standpoint of the investor there would generally not seem to be any difference in principle between taxes paid to a central government or to a provincial or state government. Accordingly, it may be desirable in some cases to specify that income or equivalent taxes paid to a political subdivision of another country would be deemed to have been paid to the government of that country, at least where the government of the other country granted a credit for income taxes imposed by Canadian political subdivisions, as well as for taxes imposed by Canada.

Integration with Canadian Individual Income Tax. We have proposed the partial integration of foreign corporation taxation with the Canadian individual income tax on the distribution of dividends to Canadian individual shareholders. A 30 per cent gross-up on such dividends and a credit against individual income tax at a rate of 30 per cent has been recommended. We estimate that this is approximately the average Canadian rate of personal income tax on foreign source corporate income 10/. A credit of this amount would, however, provide some Canadian tax revenues even though a number of shareholders would be eligible for refunds, because some tax would be collected on income derived from tax-haven operations. In addition, adoption of this rate would ensure that most Canadian shareholders would not receive less credit than they do under the present procedure. Many shareholders would have their tax credits considerably increased.

A uniform gross-up at a rate of 50 per cent for all dividends received from Canadian corporations, no matter what the source of the income from which they were derived, would greatly simplify the system for the shareholder. To achieve this result, we have proposed that at the time of making a distribution or allocation a Canadian company having foreign direct investment income should withhold an additional tax of 20 per cent of the grossed-up portion of the dividend paid or allocated to resident shareholders that was deemed to come from foreign direct investment income. For this purpose it was recommended in Chapter 19 that distributions should be deemed to come pro rata from the grossed-up amounts of domestic and foreign source income. It will be seen that a corporation having foreign direct investment income which made an allocation of taxed income would be required to make a cash payment sufficient to pay this withholding tax. A detailed method of computing and allowing credit for this tax is discussed in Appendix H to this Volume.

Levying this additional tax to facilitate the recording of distributions to Canadians, however, would have unfavourable implications if applied to distributions made to non-resident shareholders. At the present time non-resident

shareholders pay only a Canadian withholding tax on distributions paid from foreign direct investment income flowing to a Canadian company in which they hold shares. Because such dividends would continue to be subject to the regular non-resident withholding tax, it is not intended that the total taxes imposed on these shareholders should be increased. Accordingly, the special 20 per cent withholding tax should not be deducted or paid in respect of distributions to non-resident shareholders. In the case of shares beneficially owned by non-residents but registered in the names of Canadian nominees, the special 20 per cent withholding tax on distributions out of foreign direct investment income would, of course, be withheld and remitted to the government by the corporation making the distribution or allocation. In this case the non-resident beneficial owner of the shares should be entitled to apply to the government for a refund.

Where a Canadian corporation had a substantial interest of, say, at least 10 per cent in another corporation which made a distribution or allocation out of foreign direct investment income, the receiving corporation should be entitled to apply to the government for a refund of the 20 per cent tax withheld by the corporation making the distribution or allocation. It could be provided as an alternative that such a receiving corporation could file a form with the distributing corporation which would exempt distributions or allocations to the receiving corporation from the special withholding tax. In either case the distribution or allocation made out of foreign direct investment income would be treated as foreign direct investment income of the receiving corporation, so that the 20 per cent would be withheld when the receiving corporation itself made a distribution.

<u>Effect of Our Proposal for Direct Investment Income</u>. Some effects of the proposal just outlined may be briefly summarized:

1. For income received from direct investment in foreign countries levying direct taxes on corporate income of 30 per cent or more, the simplicity at present achieved under section 28(1)(d) would be retained. Some countries obviously fall into this category. We

suggest that they should be named by the administration as qualified sources. We have in mind particularly the United States and the United Kingdom.

2. The effect of requiring that at least a 30 per cent tax be paid on an accrual basis on the income of a foreign direct investment would at least partially restore equity among individual Canadian shareholders by ensuring that a substantial rate of income tax was paid on all investment income no matter where earned. We believe that this device would reduce tax avoidance by Canadians through the use of tax havens.

3. Foreign source income would be subject to progressive rates of tax. The use of an arbitrary gross-up and credit would extend to foreign source income the same procedure as that applied to Canadian corporate income. This would ensure that the progressive rate schedule would be equitably applied.

4. The credit permitted for foreign income taxes paid would be the maximum credit which is consistent with the collection of some Canadian tax revenue from foreign source direct investment income.

5. An unfortunate side effect of the proposal, although it is not as serious as it would be under a system of full gross-up and credit, would be that the tax concessions granted by under-developed countries would be "neutralized". We chose this alternative rather than the complicated provisions necessary to separate a legitimate investment in an under-developed country from a tax-haven operation. To reduce this undesirable effect, we propose that "tax sparing"—the allowance of a credit for a foreign tax whether payable or not—be authorized on a country-by-country basis. This could be done by treaty.

6. The partial integration of foreign corporation income tax with Canadian personal income tax would restore the relief that would be lost on

withdrawal of the dividend tax credit. This credit is now allowed on dividends declared by a Canadian corporation from foreign source income.

Compared with other countries (for example the United States) the foreign tax credit we recommend might appear small. The Canadian credit would be limited to 30 per cent in respect of foreign corporation and withholding taxes. In some countries the credit is 50 per cent or more. It must be borne in mind, however, that while a credit is given against the United States corporation income tax for the full amount of the foreign taxes (up to the effective United States corporation tax rate), the credit does not go beyond the United States corporation. Its value to the individual shareholder is the benefit he may derive indirectly from a reduced corporation tax. Under our proposal the benefit to the shareholder would be reflected in a direct reduction in his personal income tax and possibly in a refund of tax. The amount of the refund could be material for a low income shareholder. Throughout this Report we have emphasized that it is the tax burden on the individual that is the crucial consideration.

Business Income. The proposal detailed above also encompasses the disposition of business income earned in a foreign country through an unincorporated branch. It is now dealt with simply as income of the Canadian resident. It is taxable in full on a grossed-up basis in the year earned, whether distributed or not, with a credit for direct taxes paid to the foreign jurisdiction. We have had to bear in mind particularly that foreign branch profits of a Canadian company can be the source of dividends distributed to Canadian shareholders. We concluded that foreign business income of a branch should, as far as possible, be dealt with in the same way as income from direct investment in foreign corporations. This would, in general, provide neutrality between the different possible procedures for carrying on business or holding property in a foreign country. The credit for foreign income taxes paid would therefore be limited to 30 per cent,

and the income included in the return of the Canadian taxpayer would be the result of grossing-up the net after-tax foreign business income for taxes deemed to be paid at the rate of 30 per cent, regardless of the actual foreign income taxes paid. Also, the Canadian corporation would not be subject to any Canadian tax, over and above the amount of any special tax due if the foreign income taxes were less than 30 per cent, until such time as the foreign source direct investment income was allocated or distributed to resident shareholders. One discrepancy between forms of business organization would remain, however, as Canadian individuals operating unincorporated businesses abroad would in effect be taxed on the full accrual basis, while incorporating the business would permit them to defer their Canadian tax liability until the profits were both remitted to Canada and distributed or allocated to resident shareholders.

Portfolio Investment Income

Portfolio investment income would be that income received from foreign investments where less than a 10 per cent interest was held in a corporation, a business or a property. We recommend that, generally speaking and subject to the option referred to below, portfolio investment income should continue to be taxed as at present and that the dividend or other payment should be grossed-up for the amount of foreign withholding tax (if any) and included in income. Credit should be allowed only for the foreign withholding tax paid on the dividend or other income and not for any underlying corporation tax. However, for the reasons outlined below, we also recommend that a portfolio shareholder should be permitted to elect to be taxed as a direct investor on certain dividends received. In practice, we would expect that this election would only be used for dividends from United States and United Kingdom companies or companies in other countries designated in the regulations as being countries for which the full 30 per cent credit was allowed. However, it might be extended to other cases if the shareholder was able to provide the necessary detailed and verified information concerning the income of the foreign company and the taxes paid by it.

One reason that we are able to propose the full taxation of share gains is that, under our integration proposal, the so-called "double taxation" of corporate source income would be eliminated. On distributed earnings, only the personal rate of tax would apply. In addition, under our proposals, retained earnings could be allocated to resident shareholders by Canadian corporations in such a way as to preclude the "double" taxation of that part of share gains resulting from corporate retentions. These corporate allocations would have no tax consequences for non-resident shareholders but would be advantageous to resident shareholders. Canadian corporations thus would have everything to gain and nothing to lose from the allocation of retained earnings.

The situation of Canadian minority shareholders in foreign corporations would be completely different. If a tax credit was allowed for withholding taxes only, the underlying foreign corporation tax would be a "double" tax. Whether the Canadian shareholder derived his income in the form of dividends or share gains, he would still be subject to full personal taxes on the gross amount of the income (before any withholding tax) and would receive no credit for the underlying corporation taxes paid. Therefore, even if the present credit for withholding taxes was continued, our proposal to tax share gains in full could increase substantially the total income taxes on Canadian portfolio investors in foreign corporations—unless some additional credit was given for foreign corporation taxes.

In order that portfolio investors in foreign securities should not be unduly worsened relative to their present position, it should be provided that portfolio investors be given the option of claiming the same arbitrary gross-up and credit of 30 per cent which we recommend for direct investors if foreign corporation and withholding taxes in excess of this amount were actually paid. Because United States and United Kingdom corporations would ordinarily be deemed to have paid foreign taxes at least to the extent of 30 per cent, Canadians holding portfolio

investments in United States and United Kingdom corporations (or in corporations of any other countries which might be designated in the regulations) could in general obtain the 30 per cent credit without having to compute in detail the income of, and taxes paid by, the foreign corporation. The dividend return from these shares would become more attractive than it is now, and this would mitigate the effect of the full taxation of share gains. In many cases Canadian portfolio shareholders of corporations in other countries would not be able to determine the current income of the corporation for accrual purposes and therefore would not be able to take advantage of this option. Limitations on the application of the option may be required to ensure that the provision was not used for tax avoidance.

Non-Resident Trusts. It is quite possible that some taxpayers would endeavour to avoid Canadian tax liabilities through the creation of non-resident trusts which would receive income and accumulate it for Canadian beneficiaries. This may present a particular challenge to the Canadian tax authorities in view of the possibilities for tax deferment under such an arrangement. If the interests of the Canadian beneficiaries were contingent or were subject to the exercise of discretion by trustees, it may be difficult to devise a method for taxing such income in Canada on an accrual basis. However, to the extent that income of a non-resident trust was payable to a Canadian beneficiary or was vested in a Canadian beneficiary, we would recommend that it should be treated as direct investment income and subjected to tax under the rules we have recommended for other foreign direct investment income.

Transitional Provisions. A computation of the earnings accumulated as at the transition date by foreign subsidiaries would be important in determining the tax status of future distributions. For we have recommended that any distributions out of earnings accumulated prior to the transition date, whether they were accumulated domestically or in the foreign subsidiary, should be regarded as distributions of capital. Accordingly,

the amounts distributed would not be included in income but rather would be taken as a reduction of the cost basis of the shares held. The order of pay-out should also be similar to that recommended for domestic companies, with any distribution deemed to come first from income earned subsequent to the transition date and, to the extent that it exceeded such income, would be deemed to be paid out of surplus existing at the transition date.

TAXATION IN CANADA AS THE COUNTRY OF SOURCE

Equity and Neutrality Considerations

It is quite clear at the outset that it would be impossible to achieve equity in the sense that the income of non-residents would be taxed on the same basis as that of residents. The cardinal rule we have adopted for the taxation of residents is that all net gains should be brought into the tax base of the individual or family and the aggregation subjected annually to progressive rates of tax. This rule cannot be applied to non-residents because Canada cannot determine the net gains of non-residents that arise outside of Canada and, in fact, cannot determine all the net gains of non-residents arising in Canada (e.g., it is difficult to identify many property gains realized by non-residents). Even if this administrative hurdle could be overcome, and we are convinced that it cannot except in certain specified circumstances, the problem would not be resolved, for the total tax burden of non-residents obviously depends on the taxes imposed by other countries as well as the taxes imposed by Canada. To attempt to tax a non-resident on his Canadian source income in the same way as he would be taxed if he were a resident would mean that Canadian taxes would have to be adjusted to compensate for the other taxes paid by the non-resident. Canada would have to tax the Canadian source income of non-residents lightly if the non-resident's own government did not give credit for Canadian taxes or had heavier taxes than Canada. This would be administratively impractical; it would also mean that other nations would be encouraged to refuse to give

their residents credits for Canadian taxes, with the result that the net benefit from foreign investment in Canada would be reduced.

Having concluded that non-residents cannot generally be taxed in the same way as residents, we believe that there are basically two alternative methods of taxing the Canadian source income of non-residents:

1. A uniform rate of tax imposed on all kinds of Canadian source income.
2. Different rates of tax imposed on different kinds of Canadian source income.

The former alternative has the advantage that it would reduce the avenues for avoidance. With different rates of tax, it may be possible to achieve a substantial tax saving by changing the form of an investment in Canada or the form of a payment to the non-resident investor. The uniform rate of tax has several important deficiencies.

Because of the foreign tax credit provisions of other governments, non-residents can offset some Canadian taxes on some kinds of income against their domestic tax liabilities. In essence the Canadian tax is at the expense of the foreign treasury rather than of the foreign investor. Because the credits given by other governments are not uniform as between different kinds of income, full advantage could not be taken by Canada of these foreign tax provisions if a uniform rate were adopted by Canada.

If Canada lowered taxes that the foreign investor did not bear because of the credits provided by other governments, Canada would lose the revenue and the non-resident investor would not benefit. On the other hand, if Canada raised taxes that the foreign investor would pay because no credit or an incomplete credit was provided by other governments, foreign investment may be deterred. In the latter case, what would be gained from a higher rate probably would be more than offset by a lower base.

We have concluded, therefore, that as long as foreign governments continue to vary the credits which they provide their residents against foreign taxes paid on different kinds of foreign source income, Canada should not attempt to impose tax on such payments at a uniform rate. However, to minimize the opportunities for avoidance, in future treaty negotiations Canada should seek to reduce tax rate differentials on different kinds of income. Canadian subsidiaries of foreign parent companies can readily arrange to make payments to their parents in a form which will minimize tax. Neither parent nor subsidiary is generally interested in what the payment is called as long as it is made.

Having concluded that differential tax rates should be continued, we now consider some of the factors involved in determining the rates to be imposed by Canada.

As we pointed out in Chapter 5, there is little doubt that Canada obtains a net benefit from foreign investment. A substantial part of that benefit, but not the whole of it, arises through taxing the income flowing to non-residents from their investments in Canada. The net benefit would be increased if more Canadian revenues could be raised from this source without directly reducing the inflow of foreign capital or without bringing about retaliatory measures by other governments that would indirectly reduce the inflow.

Canada could raise the general level of taxes levied on some of the Canadian source income of foreign investors with few adverse effects. On the other hand, the present level of tax on corporate source income attributable to non-residents is substantial and, in the case of both the United States and the United Kingdom, is close to, or exceeds, the maximum amount that the non-resident investor can claim as a foreign tax credit. We have no way of knowing how sensitive foreign investment is to changes in after-tax rates of return; we do not know the effects on foreign confidence of a given tax change; we do not know how likely foreign retaliation would be

or the form it would take. Faced with this lack of knowledge, we believe that the general level of tax rates applicable to the Canadian source dividend income of foreign investors should not be increased if this could be avoided without sacrificing Canada's ability to reform its own tax system.

We are convinced that while Canada must avoid tax changes that would shake the confidence of non-residents or bring about retaliation by other governments, this concern for the interests of non-residents should not be carried to the point of guaranteeing to non-residents that, having invested in Canada in the past under a set of tax rules, tax provisions would never be changed if this would affect non-residents adversely. There are few if any domestic tax provisions that do not have some significance for non-residents. A guarantee that the tax position of non-residents would never be worsened would, in effect, freeze the domestic tax system forever. It would be extending a guarantee to non-residents that would not be available to Canadian residents and would not be made to non-residents by their own governments. We think that Canada has an obligation to provide liberal and smooth transitional provisions when the tax system is changed. Tax changes should generally apply to residents and non-residents alike. But neither residents nor non-residents should be exempt from general tax reforms merely because investments were made at a time when tax provisions were favourable.

The withholding tax rate on such income as interest and royalties, is not, however, subject to this constraint and we are recommending that it be increased from 15 per cent to 30 per cent. Initially this change would adversely affect very few non-resident investors because most are residents of countries with which Canada has tax treaties that provide for a 15 per cent rate. However, the level of tax that should eventually apply under the treaties would be a matter for future negotiations. For some payments it would appear that Canada should endeavour to collect the higher rate, while for other payments a rate of 15 per cent or less might well be appropriate. This increase would

also serve a useful domestic purpose. Although our proposal for the taxation of foreign source direct investment income should mean that income tax of at least 30 per cent would be paid on income accumulated in tax-haven countries, the higher rate of withholding tax would provide additional assurance that tax of at least 30 per cent had been paid on payments to companies in tax-haven countries. Because the 30 per cent withholding rate is the "standard" rate in the United States and approximates the standard rate in some other countries, from which reductions are made by treaty, there would be little or no risk of retaliation or of weakening foreign confidence in adopting the same rate for Canada.

The Concept of Residence

We recommend that residence continue to be the principal basis for determining liability to tax, largely because residence seems to imply a closer association than citizenship between the taxpayer and the use of services provided by a taxing jurisdiction 11/. It is the test which has been followed from the beginning of Canadian income tax and on which most of our existing practice is based.

Unfortunately the concept is not without its share of obscurity. The Income Tax Act neither fully defines the term "resident" nor indeed gives very much guidance as to its meaning. It is a product of jurisprudence, and both the literature and the cases show that it has been the subject of a great deal of dispute. The need for greater certainty would be all the more pressing under some of the proposals in this Report (e.g., the deemed realization of property gains on a change of residence), and we therefore are most conscious of the desire for further clarification. Any greater certainty by means of statutory rules can be achieved only at the expense of being arbitrary. Nevertheless some progress may be possible.

For an individual some statutory guidance is given by an arbitrary rule which deems a person to be resident on the basis of the duration of

physical presence in Canada (183 days or more in the year) 12/. However, the rules derived from case law are of equal or greater importance. They establish that the determination of residence is a question of degree and that each case turns on the facts which bear on the relationship of a person with Canada, such as, for example, the maintenance of a dwelling in Canada, the general routine of visits to Canada, the reasons for and the amount of time spent in Canada during such visits both in the taxation year and in previous years, family and other associations (clubs, ownership of property, etc.) in Canada, and similar criteria.

For a corporation, the traditional rule under the case law is that it is resident where its central management and control are situated. This is ordinarily where its directors reside and hold their meetings, with the result that a change in the location of such meetings can result in a change of the residence of the corporation. If it can be shown, however, that the central management and control are in fact exercised not by the directors but by the controlling shareholder, the corporation may be treated as resident in the jurisdiction in which the control is exercised 13/.

The importance of the traditional tests in Canada has greatly decreased in recent years as statutory rules have been introduced to frustrate tax avoidance by residence changes. Legislation enacted in 1961, 14/ provided that a company was deemed to have been resident in Canada throughout a taxation year if it was a company incorporated in Canada which carried on business in Canada at any time during the year. Under this provision, a corporation meeting both conditions was a resident even if its central management and control were outside Canada. This provision was amended in 1965 to establish that Canadian incorporation is conclusive evidence of residence for companies which were incorporated after April 26, 1965, or which were resident or have carried on business in Canada in any taxation year ending after April 26, 1965. The general effect of these provisions is that a company will be resident in Canada if its central management and

control is in Canada or if it was incorporated in Canada, unless it has been a non-resident and has not carried on business in Canada since prior to April 26, 1965.

Even with the above-mentioned statutory provision the traditional test will still apply in areas of major importance. Foreign incorporation is still a key element in many tax avoidance schemes, and it is essential that the judicial concept be applied on a practical basis if purely artificial corporate entities which are in fact managed and controlled from Canada are not to escape Canadian tax liability. We have seen that such corporations may be held to be resident in Canada notwithstanding foreign incorporation and foreign directorates, and it is possible that in some cases the Canadian tax authorities may be able to establish liability to tax on this basis.

Later we suggest changes for strengthening administrative procedures. At this point we would mention only that the annual filing of a return of assets for purposes of the proposed tax on asset gains should assist the administration in identifying the holdings of Canadians in foreign companies which may in fact be controlled and, hence, may possibly be resident, in Canada.

Carrying on Business in Canada

Unfortunately the concepts of business, and the carrying on of a business, are no more clearly defined than is residence. The Income Tax Act provides little guidance. Business is defined as including "a profession, calling, trade, manufacture or undertaking of any kind whatsoever and includes an adventure or concern in the nature of trade, but does not include an office or employment" 15/. A good deal of case law has been devoted to settling the meaning of some of the basic ingredients of this definition, such as calling, trade, manufacture, undertaking and adventure or concern

in the nature of trade, so that without reference to judicial decisions the definition as a whole is not conclusive. The courts have frequently been concerned with such terms in determining the taxable status of gains for purposes of domestic taxation, and the criteria that have emerged—such as the "badges of trade"—are of relevance to the same question when encountered in its international context.

The Income Tax Act has gone somewhat further for international purposes by providing an extended meaning of "carrying on business" in the case of non-residents. It is as follows: 16/

"Where, in a taxation year, a non-resident person

(a) produced, grew, mined, created, manufactured, fabricated, improved, packed, preserved or constructed, in whole or in part, anything in Canada whether or not he exported that thing without selling it prior to exportation, or

(b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outside Canada or partly in and partly outside Canada,

he shall be deemed, for the purposes of this Act, to have been carrying on business in Canada in the year."

The other source of guidance on the international taxation of business is the tax treaties. Over time some concepts have become common in dozens of treaties entered into between nations. Where such a treaty applies and conflicts with the general law, the treaty will prevail. In most treaties a primary requirement for taxing business earnings in the nature of "industrial and commercial profits" is that there be a "permanent establishment" of the foreign business in the country attempting to levy tax. The nature of a permanent establishment is usually defined at some length.

Adoption of our comprehensive tax base would reduce the importance of the distinction between business and non-business activities for domestic purposes. But in the international area we must continue to rely on a number of tests and safeguards to prevent avoidance of Canadian taxation through artificial devices and to frustrate those who would use Canada as

a tax haven. We have no proposals for revisions in the underlying concepts, which seem incapable of more complete or satisfactory definition in the statute; only the courts can bring these concepts into sharper focus. We suggest, however, that the "permanent establishment" concept should be incorporated into the legislation so that the existence of such an establishment would be conclusive evidence that business was carried on in Canada. Later, in our proposals on administration, we urge a more energetic use of the means that are now at hand to ensure that Canada obtains a full measure of tax on the business income earned in this country either through foreign direct business activity or foreign direct investment.

Business Income

We have only a few comments, in addition to the foregoing observations, regarding liability for tax on business income in Canada. First, the earlier recommendations made for the determination of business income would apply alike to residents and non-residents carrying on business in Canada. The main effect of this would be that gains or losses on the disposition of property would be included in the income of the business activity carried on in Canada by a non-resident. We also suggest that a non-resident should be deemed to have a permanent establishment in Canada if he holds real property or rights to real property (including mining or oil rights) in Canada. Thus, the ownership of an interest in real property in Canada by a non-resident would constitute "carrying on business". Any gain or loss on the disposition of such property or property interest would therefore be taken into account for Canadian tax purposes. The proposed transitional provisions would exclude from income any gain unrealized as at the effective date of the legislation.

In the next section, the taxation of property income derived from Canada by a non-resident is discussed. Although the definition of property income would exclude income from a business, a non-resident should be treated in substantially the same way whether he derived income directly from

carrying on business in Canada or by way of dividends from a corporation which carried on business in Canada. For this reason, we recommend that the special tax now imposed under section 110B of the Income Tax Act on a portion of the business income of a Canadian branch of a non-resident corporation be continued. This special tax should be retained at the same level as the dividend withholding tax.

Property Income

Property income—which we define as income from property in Canada other than business income—is subject to a withholding tax, generally at a rate of 15 per cent. The withholding tax technique, and its application to this particular form of income, raises questions as to the theoretical basis for a tax of this type, the proper scope of its application and the appropriate rate.

The withholding tax is a rough-and-ready alternative to the generally unenforceable requirement that non-residents file a tax return on their world income. It represents a major but inescapable departure from the taxation of income at graduated rates.

Statutory withholding rates reflect nothing more than a judgment as to the best level from which to start the bargaining process with other countries for mutual reductions. By this process rates of 30 per cent or higher which are imposed by the law of some countries have in most treaties become a bargained rate of 15 per cent.

We have considered whether in this light the statutory level of the Canadian withholding rate should be higher—perhaps double its present level of 15 per cent.

In the case of dividend payments, we have concluded that such an increase would conflict with our general objectives set out earlier in this chapter. A higher level than the present 15 per cent might discourage

some foreign investment unless the investor was able to obtain a foreign tax credit for the full amount of the tax withheld, and this is unlikely. Therefore, we do not recommend any increase in the rate of withholding on dividends. We recommend that the rate should be the same regardless of whether the corporation had a degree of Canadian ownership. In the case of many companies the rate is now 10 per cent, and in fact some companies have issued shares to the Canadian public in reliance on the present law. While in many cases the 15 per cent rate would not result in hardship since it could be claimed as a credit against foreign tax, this would not be true in all cases. Accordingly, we suggest that the rate might be fixed at 15 per cent and then a reduction to 10 per cent offered in treaty negotiations with other countries. In the event that shares of a company were issued or sold in order for it to qualify for the lower rate of withholding tax and it was not covered by a treaty providing for a 10 per cent rate, special provision should be made to continue the withholding rate at 10 per cent.

We are inclined to a different view with respect to payments which leave Canada without having suffered any burden of Canadian direct taxation because they are deductible in computing taxable income (e.g., royalties, rentals, interest and similar payments). On payments of this nature the withholding tax is the only tax collected by Canada. A higher level of withholding tax would increase Canadian revenues with relatively small danger of an unfavourable effect. In addition, it would be useful in treaty negotiations if the general level of Canadian withholding tax exceeded that which Canada was willing to levy against payments flowing to the country with which the treaty was being negotiated. We therefore recommend that the general level of withholding tax should be increased to 30 per cent, but that Canada continue to reduce this rate when specific circumstances warrant a lower rate for certain countries and certain kinds of payments. In fact the rate would be restricted to 15 per cent under many treaties which are now in effect. However, for many kinds of payments, and in the absence of reduction of the rate by treaty, it would be to Canada's advantage to

impose a rate of withholding tax that was higher than 15 per cent.

There is an additional problem in that the credits for foreign taxes provided by some countries make it advantageous to change the form of the investment in a foreign subsidiary.

With a Canadian corporation tax of about 50 per cent, and a maximum Canadian withholding tax of 15 per cent, most foreign parent corporations can offset most of their Canadian taxes against their domestic taxes. Substantial reductions in their Canadian taxes would not reduce, therefore, the total taxes paid by the parents. Under the United States tax system, domestic parent companies with subsidiaries in a number of different foreign countries can determine the limitation on their United States foreign tax credit either separately for each country or on an overall basis aggregating the income of and taxes paid by all foreign subsidiaries. The low foreign taxes paid in some countries can then be used to offset the high foreign taxes paid in other countries. Furthermore, foreign withholding taxes on dividends, interest (with certain exceptions), royalties and other returns on capital are treated on the same basis as foreign corporation income taxes in computing the United States foreign tax credit. If a United States parent cannot completely offset Canadian corporation taxes and Canadian withholding taxes against its United States tax liabilities, it has an incentive to change the form of its investment in its Canadian subsidiary to reduce the Canadian corporation tax. If the United States parent has foreign source income from countries other than Canada, and to the extent that the taxes in these other foreign countries are greater than the United States tax liability, the parent will have an incentive to reduce its Canadian taxes. This can be done by taking the return from the Canadian subsidiary in a form other than dividends.

To put this rather complex matter in a slightly different way, a United States parent has nothing to gain from a reduction of the Canadian income tax on its subsidiary if the Canadian tax can be fully offset by

United States tax credits. However, to the extent that Canadian taxes are greater than United States taxes, or that the taxes of a subsidiary in a country other than Canada or the United States are greater than United States taxes, there is something to be gained by reducing Canadian taxes. Because it may be relatively easy to change the form of a United States parent's investment in a Canadian subsidiary without affecting the substance of its investment, the present tax system, which imposes a tax of 50 per cent on earnings plus 15 per cent on dividends, or a total of 57.5 per cent, but only 15 per cent on interest, royalties and other returns on capital, provides ample scope for this kind of manipulation.

On the basis of investigations we have made, we do not believe that this transformation of dividend payments into other forms of payment has been an important problem in the past. Nevertheless, with declining United States corporation taxes, rising foreign corporation taxes and pressure from the United States Government on United States parents to remit the earnings of foreign subsidiaries to the United States, we can foresee a time when this could become a serious problem for Canada—particularly in the case of subsidiaries of United States companies established in Canada in the future. We believe that Canada is now obtaining adequate tax revenues from most foreign investment in Canada. However, if part of the Canadian source income from direct investment by non-residents should, in effect, gradually become subject to tax at 15 per cent rather than 57.5 per cent, the net benefit to Canada from foreign investment would be substantially reduced.

Adoption of the recommendation in Chapter 19, that certain payments of interest by a subsidiary to a non-resident parent company should be deemed to be dividends and therefore not be deductible, would reduce the number of instances where manipulation between these types of payments could occur. Nevertheless, a narrowing of the differential between the total taxes levied on returns from different forms of capital investment

would also appear to be an appropriate objective. Such a narrowing is difficult because of the conflicting objectives of attempting to obtain the maximum tax revenue from foreign investment while not raising taxes to a level that would discourage such investment. A substantial reduction in the taxes currently levied on dividends could be costly in terms of revenue, while a substantial increase in the rate of tax on interest might reduce this desirable form of foreign investment. At this time, therefore, we recommend only that the basic rate of withholding tax on interest payments (and other forms of return on capital other than dividends) be increased and that possibly a small reduction in the rate of withholding tax on dividends be offered by the government in future treaty negotiations. The latter change, to a rate of, say, 10 per cent, should preferably be accomplished by tax treaty and should be accompanied by equivalent concessions on the part of the other country signing the treaty. Such a reduction in the dividend withholding rate would have the added advantage that, to the extent that it benefited the non-resident investor and did not merely increase his domestic taxes payable, it would at least partially match the added incentive given to most Canadian investors by our proposed integration of the Canadian corporation and personal income taxes.

The exemption from Canadian withholding tax of interest paid to tax-exempt foreign investors should be continued. These are important sources of investment capital for Canada. Because the foreign investor is tax-exempt, he is unable to claim a tax credit for any Canadian tax paid. The imposition of a withholding tax on payments to such lenders would probably only increase the rate of interest charged to the Canadian borrower. In the 1966 amendments to the Income Tax Act this exemption was extended to all non-resident investors with respect to their holdings of federal and provincial government securities issued after April 15, 1966. 17/ While the extension of this exemption to taxable investors would appear to provide only limited direct benefits to investors, there are apparently some potential buyers of government securities who regard the withholding tax

as significant. However, any further extension of this exemption (e.g., to corporate securities) would appear to involve disadvantages that would outweigh the possible attractions. Not only would the effect of such a measure be limited, so that it would be an inefficient incentive, but it would be necessary to impose a number of restrictions to prevent the exemption from being used by regular investors as a means of withdrawing income from Canada free of tax.

Personal Service Income

We have considered whether there might be any feasible or desirable alternative to the present procedure under which a non-resident employed in Canada files a return of his employment income earned in Canada and pays tax thereon at graduated rates as if the Canadian income were his total income. There appear to be only two other methods worthy of consideration.

Under the first alternative, the taxpayer would be required to file a return showing his total world income, including his Canadian income, and would be taxed at a rate determined on this basis. As we have said previously, we are of the opinion that such a requirement would be difficult to enforce. The Canadian tax authorities would have no means of verifying the total income other than to obtain certified copies of the taxpayer's foreign tax return, and almost no recourse if the Canadian return were found to be false when the taxpayer was no longer receiving income from Canada.

The other alternative would be to impose a flat-rate tax on personal service income similar to the withholding tax on property income. This is the practice of the United States with respect to non-resident aliens who are not engaged in trade or business in the United States (as defined), and who are subject to a tax of 30 per cent in lieu of all other income tax.

We believe that the considerations for and against such a withholding tax are about equally divided. On the one hand, it can be argued that the withholding tax device has been accepted as appropriate for many other

forms of income and that it could as easily be applied to employment income. On the other hand, it can be said that the imposition of a flat-rate tax on many forms of payment is dictated by the differing income levels of the foreign recipients, the flat rate being a compromise of the varying marginal rates that would apply if the foreign recipients were to pay tax as Canadian residents, and that such an average rate means that some are overtaxed and some undertaxed.

Although the present system is not seriously deficient, the application of progressive rates to only that portion of the person's income which is earned in Canada is a departure from the principle of full progressive taxation and so is not satisfactory. Therefore, we recommend that consideration be given to levying a withholding tax at a flat rate of 30 per cent on personal service income earned in Canada by non-residents, and granting relief to recipients who would have been subject to lower rates by permitting the non-resident to elect to be taxed as a resident of Canada and, accordingly, to file a return reporting his world income. This option is discussed further below. Although control of the refunds would largely be dependent upon the honesty of the taxpayer, the procedure should nevertheless increase tax revenues. This same rate of withholding tax and the same right of election should apply with respect to the income portion of pension and annuity payments as discussed in Chapter 16.

We have also been impressed with the magnitude of the flow of payments from Canada for personal services not requiring the physical presence in Canada of the person rendering such services. These are mainly fees for consulting, professional, management and administration services, shown in the 1962 report under the Corporations and Labour Unions Returns Act (p. 41) to be in excess of $100 million. This compares with $169 million reported by corporations under the same Act as interest payments to non-residents. As the non-resident is not physically present in Canada, these payments are generally not taxable under the present legislation.

One reason for making a tax distinction between international income from capital, which is taxed where the capital is employed, and international income from services, which is taxed where the person physically performed the services rather than where they are exploited, is perhaps that the latter is more likely to involve substantial foreign-based expense than is the provision of capital. But this would support the imposition of a lower withholding tax on services than on property income, rather than complete exemption. Furthermore, the requirement of physical presence in the country seems to rest on assumptions that are being undermined by the development of modern communications media. The taxation of remuneration for many forms of services does not appear to present major problems of tax enforcement by the source country. Some definitional problems would exist, at least initially, but these could readily be met if a broadly based tax was applied to most payments for services. The present treatment results in frequent anomalies such as, for example, the imposition of tax on the portion of a payment that relates to a fee for the use in Canada of some property, say, a patent, and the exemption of the portion of the payment that is applicable to the management advice on how to use the patent.

In our view there is justification for the taxation of income from personal services by the countries in which they are exploited. The rate of withholding tax might be of the order of 10 per cent. Because this tax would generally not be eligible for a foreign tax credit in the country of destination, a relatively low rate should be imposed.

It is not intended that this withholding tax should be imposed on payments for services of a personal nature. It should be applied only where the benefit of the services was enjoyed in Canada and where the payment was deductible in computing business or property income for Canadian tax purposes. Since it would be a tax on payments for services, it should not apply to amounts paid in reimbursement of expenses. The exclusion for expenses would have to be carefully defined, having regard to the difficulties

that can arise in distinguishing between a payment for services and a reimbursement of an ordinary expense.

Gifts and Payments from Trusts and Estates

Our recommendations in Chapter 21 for the taxation of trusts and estates involve the payment of initial tax on income received by the trust or estate. This tax would be imposed at different rates depending upon the type of income and the beneficiary to whom it was distributable or for whom it was accumulated in the trust.

We proposed that income of a trust (other than gifts and inheritances and income from direct foreign investment) which was distributable to non-resident beneficiaries or was accumulated for the benefit of non-residents should be subject to initial tax at the rate of 50 per cent. The initial tax would, of course, be reduced by any credits to which the trust was entitled in respect of dividend income from Canadian corporations. Upon payment being made to a non-resident beneficiary, the recipient would not be entitled to any credit for the initial tax and there would be a further withholding tax at the rate applicable to dividends.

We have also recommended that because of the hardship which might be caused by the imposition of both the 50 per cent initial tax and the withholding tax, a non-resident beneficiary should be entitled to elect that instead of these taxes the income payable to him should be subject to the same withholding tax which would have been payable if his allocable share of the income of the trust from each source had been paid to him directly. Accordingly, if the trust had income from interest or rent or similar sources, a non-resident who made this election would in effect pay a tax of 30 per cent on his portion of that income and would obtain a refund of any tax in excess of this amount which had been paid by the trust.

Income of a resident trust from foreign direct investment would be taxable in the same way as similar income received by a corporation. Gifts received by a trust, including property passing on death in the case of a trust arising on death, would be subject to initial tax at the rate of 30 per cent. Income of these types would not be subject to any further withholding tax on distribution to a non-resident beneficiary.

The creation of non-resident trusts and resident trusts with non-resident beneficiaries for tax avoidance purposes has been on the increase. In 1965 a special provision was enacted to deny generally a deduction to trustees of business income paid to non-resident beneficiaries and non-resident-owned investment corporations 18/. This is an example of a type of avoidance that seeks to extract from Canada income which ordinarily would be subject to higher rates of tax, by paying only the withholding tax. The proposed withholding taxes should reduce this type of avoidance, particularly with respect to business and dividend income and gifts.

Optional Filing of a
Canadian Tax Return

We have concluded that it would be impractical under most circumstances to require non-residents to file Canadian tax returns and to report their world income to Canada. However, we have also suggested that the level of withholding taxes on certain kinds of income should be higher and that withholding taxes should be imposed on some other kinds of remittances to non-residents that are not now taxed. In Chapters 15, 16 and 17 which are concerned with these particular types of payment (property income, deferred income and gifts including inheritances) we have pointed out why the withholding tax on these payments should be at a substantial level (i.e., at least 30 per cent). We have also acknowledged that while a withholding tax rate of less than 50 per cent creates possibilities for tax avoidance, a rate close to this maximum level could result in severe hardship for low and middle income taxpayers. It is for this latter reason that we recommend a rate of 30 per cent for

payments to non-residents of gifts, bequests, the income portion of pension and annuity payments and perhaps for certain employment income. However, even this rate could be inequitable for some recipients. We have therefore suggested that a non-resident receiving such a payment should be permitted to file a Canadian tax return on his world income as though he were a resident. In computing the Canadian tax payable, credits for foreign income taxes on foreign source income up to an amount equal to the Canadian tax on foreign source income would be deducted in the same manner as at present. For these taxpayers no credit would be given for any foreign tax on Canadian source income. Such a non-resident would obtain a refund of that portion of the Canadian withholding tax which exceeded the Canadian tax payable on the optional basis.

We have also suggested that any Canadian resident who became a non-resident should be permitted to elect to continue to be taxed as a Canadian resident, provided this election was made each year after the change of residence. This would preclude a deemed disposition of his property holdings, an event that we have recommended should take place when a taxpayer ceased to be taxed as a Canadian resident. This type of election would be necessary for the taxpayer who became non-resident and wished to continue his membership in an individual Registered Retirement Income Plan. (Non-residents would be eligible for membership in registered group plans.) This election would also be useful for a dependant who became non-resident but wished to remain a member of his family unit. By making the appropriate election he could receive gifts and bequests from other members of the family unit free of withholding tax, and transfers of property to such a dependant would not be dispositions by the family unit (which might result in taxable gains). A non-resident spouse would be exempt from the withholding tax on a gift from the resident spouse in any event, but would have to make this election to prevent a disposition from occurring for tax purposes on a transfer of property from another member of the family unit. It is likely that in practice this kind of election would be made only where the change of

residence was expected to be temporary. For taxpayers making this election credit should be given for all foreign income taxes on foreign or domestic source income on the same basis as under the present law, the credit being limited to the effective rate of Canadian tax on the same income.

Although the accuracy of the Canadian return would be difficult to verify, even if the taxpayer was required to submit a certified copy of his foreign tax return, the fact that the filing of the return would be optional, and that the government need not make a refund unless it was satisfied with the information supplied, would distinguish this procedure from one that required a non-resident to file a Canadian return. A substantial proportion of those making the election would probably be former Canadian residents for whom the Canadian tax authorities would have earlier returns.

We also accept that it would be reasonable to modify the withholding tax principle where the payment was one against which substantial business expenses should be offset. At the present time, an option is granted for the filing of a tax return with the Canadian authorities where the income received is from real estate rents and timber royalties. We would be prepared to see the right to file a net income return extended to other forms of payments to non-residents if the administrative difficulties were not too severe. In making this suggestion, we propose that any expenses that might otherwise be claimed as deductions in computing the net income, but which would be subject to withholding tax if paid by a Canadian resident, should not be deductible. In the case of employment income, we question the suitability of applying progressive rates only to that portion of the taxpayer's income that was earned in Canada. Accordingly, if the election was made, the return and claim for refund should be based upon the world income of the taxpayer.

Special Corporations

Two special classes of corporation are of particular significance in the area of international taxation in Canada: the foreign business corporation and the non-resident-owned investment corporation.

Foreign Business Corporations. A foreign business corporation is one which carries on substantially all its business outside Canada (section 71 of the Income Tax Act), although it may be incorporated and resident here. As such it enjoys complete exemption from Canadian tax. The category was first introduced in broad terms in 1918, and the legislation was amended in piecemeal fashion over a period of forty years as inconsistencies and abuses became apparent. It finally appeared that the provisions were not only giving too much scope for tax avoidance by Canadians but were also attracting foreigners who, according to the Minister of Finance of the day, "were interested in using Canada as an address but not as a home", thereby facilitating international tax avoidance on a grand scale. This occurred principally through purchases of goods in the United States and their sale in other countries under the protection of Canada's treaties. In 1959 the provisions were restricted in their application to corporations which qualified as foreign business corporations in that year and continued to so qualify annually thereafter. The number of foreign business corporations is therefore gradually declining, but some remain. Some of these are genuine in the sense of being corporations which the original legislation was intended to benefit. But many are products of ambitious tax avoidance plans. It seems to us anomalous that no restriction was placed on changes of control of corporations which qualified for the exemption in 1959 because the shares of these corporations are now seen to change hands from time to time, presumably as one group completes a tax avoidance scheme and another wishes to begin one.

We see the foreign business corporation provisions as being openly discriminatory and as favouring international tax avoidance. On these two grounds we recommend their entire repeal. Where a substantial business organization has been built up on the basis of existing rules, however, there is always an argument that a sudden change will create an unjustifiable hardship. Because some of the longest established Canadian corporations can

present this argument against repeal, we think that it may be reasonable to spread the repeal over several years and afford such taxpayers an opportunity to adjust their affairs. Canada would probably lose some revenue as a result of the entire repeal of the provision but, on balance, it appears unlikely that it would be significant. We recommend, therefore, that the foreign business corporation provisions cease to apply to any corporation after, say, five years, and that they cease to apply immediately to any corporation which is not a public company listed on a recognized Canadian stock exchange.

Non-Resident-Owned Investment Corporation. Under section 70 of the Income Tax Act, a corporation which is 95 per cent owned outside Canada may elect to pay a tax of 15 per cent on its income, provided such income is of a defined kind. In general, the income must arise from ownership of, or trading in, investments such as bonds, shares, debentures, mortgages, etc.; from the lending of money; from rents, hire of chattels and similar remuneration; or from estates and trusts. It is a condition that not more than 10 per cent of the income arises from rents and that the principal business of the corporation is not the lending of money or dealing in securities or mortgages, etc. No further tax is payable on withdrawal of the funds of the corporation by its non-resident owners.

The net effect of the provision is to anticipate the 15 per cent withholding tax on dividends paid to non-residents and to reduce to 15 per cent the rate of corporation tax that would otherwise apply to such income as interest, rent, royalties, etc., if received by an ordinary corporation.

The general rationale for this measure, developed since its introduction in the less sophisticated tax climate of 1936, is that it encourages the investment of foreign funds in Canada at little tax cost to the government.

We question whether the true interests of Canada are served by this provision, particularly in the light of the tax-haven opportunities which

it presents. Analysis of the provisions themselves suggests that they do not tend to encourage portfolio investment in Canadian equities, but rather encourage investment in interest-bearing securities and rental properties. Non-resident-owned investment corporations (NRO's) are subject to tax at the rate of 15 per cent on all their taxable income, including dividends from Canadian corporations. The inclusion of such dividends places NRO's at a disadvantage in comparison with ordinary Canadian corporations. The natural form of organization for non-residents wishing to invest in a portfolio of Canadian shares would be an ordinary Canadian corporation; in that event all Canadian tax would be deferred until the holding company paid dividends to its shareholders, and a faster rate of accumulation would be possible than with an NRO. For interest and rental income, the NRO is clearly preferable because a rate of 15 per cent is substituted for the ordinary rate of corporation tax.

We conclude that the effect of the NRO legislation in its present form, whatever purpose may have been intended or ascribed to it, is to enable non-residents to invest in interest-bearing securities and to invest directly or indirectly through subsidiaries in rental properties at rates of Canadian tax no greater than the rates of withholding tax. If this is an encouragement to investment in Canada, it is achieved by creating a mechanism which permits the foreign investor to avoid the tax of his home country without Canadian penalty. We find that the NRO provisions are contrary to our philosophy that we should not facilitate international tax avoidance. We therefore recommend that the NRO provisions be withdrawn, although this should be done gradually and with suitable transitional provisions, because of the large number of corporations now qualifying for the special treatment. It might be provided for example, that after the effective date the only corporations that could qualify as NRO's would be those that qualified as such in that year and in each subsequent year and that reduced the amount of their net assets by at least 10 per cent in each year subsequent to the effective date. The provisions could then be completely withdrawn after ten years.

ADMINISTRATION

Elsewhere, we recommend steps which we feel will result in an improvement in the level of federal tax administration. We have some particular recommendations for international taxation.

International Tax Avoidance

One of the most challenging problems in the administration of international taxation is the avoidance or reduction of tax liability through transactions with persons in another jurisdiction who are not at arm's length with the taxpayer. The difference between the domestic situation and the international situation is one of degree rather than of kind. The problem of checking and circumventing tax avoidance in non-arm's length transactions in the international field is greatly magnified by the fact that the Canadian authorities are limited both by jurisdictional and by practical considerations to reviewing only one side of the transaction. A few of the general areas in which this avoidance can take place—we do not consider details of the individual kinds of transaction—are indicated in the following discussion.

Inter-Company Transactions. By charges or payments for goods or services at prices other than market—at either abnormally high or abnormally low levels—associated companies may transfer profits from high tax to lower tax jurisdictions. The problem is not greatly different from that frequently encountered between taxpayers within the same country, and can be combatted only by a constant surveillance by the tax administration of inter-company pricing practices. A device that might be used would be to require special detailed annual reporting of all charges between international companies not dealing at arm's length. It might also be required that where an inter-company charge differed substantially from cost the taxpayer must satisfy the tax authorities that the profit was a fair one.

One of the greatest gaps in the international taxation of business

profits, and one from which many other difficulties stem, arises from the absence of any generally accepted rules for the allocation of earnings between countries when a business operates in several countries either through branches or subsidiaries. Such agreed rules would be comparable, for example, to those used in Canada for the allocation of profits between provinces for purposes of provincial taxation, since exactly the same issues are involved. The present general approach, as embodied both in national statutes and in international tax treaties, is to start with the profits as shown by the books of the company and make whatever adjustments can be justified. Failing this, there is seldom any other agreed approach. The United States is an exception, having provided by law a statutory allocation formula which operates when a reasonable allocation cannot be made either on the basis of independent factor cost or by adjusting the books of the taxpayer.

We recommend that the Canadian tax authorities study the implications of adopting a formula as an alternative to the adjustment of the books of account and of giving that formula official sanction by regulation. Where possible such a formula might be incorporated into some of the international tax treaties to which Canada is a party.

Situs of a Transaction. Generally, the rule is that a sale is concluded at the place where the contract for the sale of the goods is made. This provides legal opportunity for locating the situs of a transaction at a tax location suitable to the taxpayer—that is, a low tax jurisdiction—by a device no more elaborate than the incorporation of a company which maintains records. Because the rule itself is a fairly reasonable one, the resulting tax avoidance can most properly be overcome by general measures intended to ensure the immediate or ultimate taxation of the profit on such transactions; the recent United States measures and the proposals we have made earlier with respect to tax-haven companies should achieve this result.

Transformation of Payments. The pressure for the transformation of payments

from a taxable to a non-taxable form arises when, for example, dividend payments to a parent company are paid out of after-tax profits and are subject to a withholding tax. Attention centres on the transfer of profits to the parent by way of enhanced payments for management services, patents, copyrights, research, advertising, etc. Recent Canadian extensions of the scope of the withholding tax have apparently been directed against such practices.

If dividends must be paid out of after-tax income while interest is a business deduction, increased emphasis will be given to a debtor-creditor relationship between the companies so that inter-company payments will take the form of interest rather than dividends. We have already discussed this matter in dealing with the withholding tax.

Organization and Staffing

We recommend that special groups be developed both in the Department of Finance and in the Department of National Revenue (or its successor) to serve in removing causes and instances of overtaxation, in reducing causes and instances of international tax avoidance and in increasing co-operation with the tax authorities in other countries.

Among the responsibilities of the group in the Department of Finance might be the following:

1. To consider representations made by taxpayers with respect to Canada's international taxation policies and legislation.

2. To keep abreast of changes in the tax laws of other countries and the implications of these for the taxation of international transactions by Canada.

3. To work closely with their counterparts in other countries in developing solutions by statute or treaty to problems of overtaxation and undertaxation that come to its notice.

4. To advise on taxation policies generally and tax legislation in particular as they affect international operations.

5. To advise on and engage in treaty negotiations.

6. To keep abreast of techniques for international tax avoidance and to advise the tax administration on areas that should be subjected to particular scrutiny.

Among the functions of the group in the Department of National Revenue (or its successor) might be the following:

1. To deal with taxpayers having specific international tax problems and in particular to give advance rulings in the international area.

2. To determine taxpayer reporting requirements so that information would be obtained in a form that was most useful for assessing purposes.

3. To draft regulations and bulletins relating to international transactions.

4. To apply special matching and investigation procedures to certain tax returns and information.

5. To keep abreast of the tax laws of other countries and their administration.

6. To advise the Department of Finance of areas that were proving troublesome under existing legislation and treaties.

There would be need for close and continuous liaison between the two groups to prevent duplication of effort and to facilitate development of tax policy.

The tasks that we have referred to above would require larger staffs than are now engaged on international tax problems in the Departments of Finance and National Revenue. For example, the information returns we recommend below, far from allowing the assignment of less manpower to the

assessment of international transactions, would require more assessors if the potential was to be realized.

Moreover, given the complexities in this area of taxation, the staff assigned to it must include an unusually high proportion of people who were experienced in selection and investigation techniques and had knowledge of the ways in which non-arm's length situations may be exploited for tax purposes. Indeed, the staff should be the equal in imagination to those who were engaged in arranging transactions to minimize taxation.

The need for increased staff would be more marked in the tax administration area because of the division of responsibilities between the two departments. As the administrative group dealing with international tax problems broadened the scope of its activity, it would no doubt be found desirable to disperse the staff among the various regional offices.

Reporting and Returns. We have mentioned several areas in which provisions of the Income Tax Act have permitted tax manipulation in international transactions. While we believe that, even under the present provisions, additional tax could be assessed on many such transactions, this would involve reporting, selection and examination procedures for which the Department of National Revenue staff in the international area is not now equipped.

We believe that several of the recommendations made for the income tax structure generally, for example, the annual detailed information returns on holdings, acquisitions and dispositions of assets (integral to the taxation of gains on dispositions of capital assets), would tend to reduce tax avoidance substantially. In addition, we specifically recommend a detailed reporting of international transactions between taxpayers not dealing at arm's length. Adaptation of electronic equipment to the processing of this information would add greatly to its potential usefulness. However, receipt and processing of this information in mass would not automatically provide an effective solution to the problem of tax avoidance in connection with

international transactions; it would be necessary to select from the mass particular operations for further examination and, where indicated, close scrutiny.

We have recommended that persons emigrating from Canada should be required to obtain a tax clearance to ensure that the full Canadian tax, including that levied on any gains from the deemed disposition of property, has been paid. In order to ensure that all persons emigrating appreciate that this requirement exists it would be necessary to ask a brief question of people leaving the country. Those signifying they were emigrating would be asked additional questions to ascertain whether they had final tax clearance. So that this requirement would not unduly delay travel, it would be possible to waive such questioning at border crossing points during periods when there is substantial commuter traffic.

Exchange of Information. Canada's tax treaties now provide for the exchange of tax information and for the transmittal by each country to the other of certain routine information on an annual basis. The Canadian tax authorities should discuss with their counterparts in countries using electronic equipment for processing tax returns various ways in which such equipment might be utilized to provide routine information in a more effective form than is now done. For example, copies of all Canadian withholding slips on payments to United States residents are currently supplied to the United States authorities. We would also recommend that while Canada should be prepared to negotiate with other governments concerning the exchange on request of further available tax information, it should be a condition to the supplying of information that it be made available on a confidential basis to tax officials only.

THE TAX TREATIES

The discussion in this chapter relates basically to the Canadian statute law and jurisprudence, reference having been made only occasionally to the effect of the tax treaties into which Canada has entered with other countries. What follows is a brief discussion of their major points.

The treaties, of which Canada now has thirteen (not counting three additional treaties which have been signed but not proclaimed in force), are an important international fiscal device. As a negotiated arrangement, a treaty provides a flexible means of reconciling otherwise conflicting features of the basic tax systems of individual countries; at the same time, they have presented the opportunity for developing rules of international tax behaviour which have become embodied in "model" treaties sponsored by organizations such as the League of Nations, the United Nations and the Organization for Economic Cooperation and Development. Frequently, the effect of a treaty is to substitute some of these "model" concepts for the basic national tax statute, since the treaty terms override the provisions of the domestic law.

Canada's oldest treaties were with the United States (1936) and the United Kingdom (1946). The treaty with the United States was replaced by a broader one in 1941. The treaty with the United Kingdom was terminated effective January 1, 1965, and a new, more limited treaty came into effect at that time. Subsequently a new treaty was signed but has not yet been proclaimed in force. In addition, there are income tax treaties with Australia, Denmark, Finland, France, Germany, Ireland, Japan, The Netherlands, New Zealand, Sweden and South Africa. A new treaty with Ireland and treaties with Norway, Belgium and Trinidad and Tobago have been signed but have not yet been proclaimed in force. Canada also has treaties regarding estate tax with five countries.

The main purpose of the treaties is to facilitate world trade and investment by avoiding double taxation or discriminatory tax practices and also to prevent tax avoidance and evasion by providing for the exchange of information and other forms of co-operation.

Prevention of Double Taxation

The treaties often give more precise definitions than the domestic tax legislation. They remove uncertainty by such means as specifying the taxes levied by each country which will be regarded as income taxes; by defining such concepts as "person", "company" and "resident"; and by establishing an agreed basis for the taxation of profits. Usually it is agreed that the taxation of the profits of an entity of the other country will be limited to the "industrial

and commercial" profits of a "permanent establishment", the latter term being extensively defined but in essence being a fixed place of business.

The treaties also exempt certain forms of income. Where it is administratively more convenient to exempt income than to require taxpayers to go through the process of reporting and claiming a tax credit, countries having approximately the same weight of taxation will frequently adopt this device. Provision is often made for the exemption of the profits of international shipping and aircraft companies. Frequently, annuities, pensions and similar income are exempted from withholding tax, and remuneration of employees of the other government is also dealt with. Where residents of one country earn income during short visits to the other country, exemption is also frequently extended as an administrative simplification.

The treaties provide a limitation of the right to tax. Most often restricted is the right to withhold tax on dividends, interest and similar payments. Under some of Canada's treaties, the 15 per cent rate has been reduced and, in one or two cases, completely eliminated on a reciprocal basis.

The contracting parties undertake to allow a tax credit in respect of income taxed at source in the other country. This feature of Canada's treaties, often of great significance in treaties of other countries, has been of minimal importance as far as Canadian tax is concerned because Canada has allowed a tax credit for foreign taxes almost from the beginning of the income tax.

The treaties usually provide that where double taxation exists in the case of an individual taxpayer the "competent authorities" of the two countries may consult in an effort to relieve the problem.

Prevention of Fiscal Evasion

Usually the provision for exchange of information is very broadly phrased and stresses the purpose of preventing fraud and evasion.

Where an enterprise in one country has a permanent establishment in the other country, a general procedure is sometimes set out for the rectification of the accounts of the latter so as to reflect the profit it might have derived if it had been an independent enterprise.

Provision is usually made for joint consultation and administrative co-operation in the carrying out of the terms of the treaty.

Appraisal

We approve of the present extent of Canada's treaty arrangements and suggest that further treaties be negotiated with other countries with which Canada has close or growing trade and financial relations, such as Italy, Switzerland, Mexico, Venezuela, India and Brazil. We also find encouraging the trend toward the adoption of model treaty arrangements, although we have some reservations as to the extent to which any one model, such as that promulgated by OECD, can be adapted to the needs of all countries. It is obvious that changes in international taxation are rapid and complex, and Canada's treaties must be kept constantly under review to cope with new concepts and conditions. We have already proposed administrative changes to this end.

Much can also be gained from the fullest exchange of information under Canada's treaties, and we have proposed administrative changes that will facilitate such exchange. Canada's treaty with the United States should provide that any information supplied by Canada should be restricted to the use of the Internal Revenue Service, a feature of several United States treaties with other countries.

An aspect of the treaties that calls for improvement is the "competent authority" provision. The present arrangements are unsatisfactory, resting as they do on the sufferance of the contending tax authorities. In our opinion, the determination of the existence and degree of double taxation should be made the responsibility of a tribunal consisting of a representative from each country and a third member chosen by them. This tribunal should have power, on a finding of double taxation, to allocate income between the two countries or even to allow a rebate on equitable principles.

It is also our opinion that a serious lack in the international area is the absence of co-operation in the enforcement of tax liabilities to other countries. We have proposed in Chapter 33 that arrangements be entered into by treaty, under which, on a reciprocal basis, Canadian courts would enforce liabilities owing to another country by persons over whom they had jurisdiction.

CONCLUSIONS AND RECOMMENDATIONS

OBJECTIVES

1. The proposed domestic tax system is radically different from the tax systems in effect in other countries. It is therefore of prime importance to develop provisions for the taxation of international income flows which would be consistent with our proposed domestic reforms and which:

    a) would not adversely affect our economic ties with the rest of the world;

    b) would maintain and preferably increase the net economic benefit which Canada derives from foreign investment; and

    c) would not abrogate our treaty obligations or offend against the normal standards of international taxation.

2. It is also essential to tax foreign source income of Canadians, like other kinds of income, at full progressive rates, develop procedures that minimize tax deferment and close the loopholes in the present system which are exploited by the use of tax havens.

3. The differences in the rates of tax that apply to different kinds of Canadian source income of non-residents provide avenues for avoidance and so reduce the net economic benefit derived by Canada from foreign investment. Reducing these disparities would be desirable.

4. International tax neutrality is probably unattainable and perhaps not even desirable while there exist other economic barriers such as tariffs, immigration laws, foreign investment guidelines and foreign exchange controls.

5. Although it is in Canada's long-run interest not to erect new international economic barriers or induce other countries to do so, it is virtually impossible to establish principles for the taxation by Canada of international income flows in order to achieve the best possible allocation of world resources. For this reason, it is necessary to take a more pragmatic approach in the international field than in domestic taxation.

GENERAL CONCLUSIONS

6. Canada should not extend the benefits of the proposed integration of personal and corporation tax to non-residents.

7. The level of tax on foreign shareholders of Canadian corporations should not be raised except where necessary to carry out domestic tax reforms.

8. To increase the net economic benefit to Canada and to reduce the avenues for tax avoidance, the withholding tax on payments other than dividends which are made from Canada to non-residents should be increased.

9. Canada should not seek to tax non-residents on their Canadian property gains except those realized in connection with a business carried on in Canada (defined to include transactions in real property or an interest in real property which is located in Canada).

10. Canada should give residents credit for foreign withholding taxes and foreign corporation taxes actually paid at a rate that would ensure that the Canadian taxes on such dividends did not increase for most shareholders.

SPECIFIC RECOMMENDATIONS

11. The present exemption from tax of certain foreign dividends received by a Canadian corporation which is provided by section 28(1)(d) should be withdrawn, and a new method devised for taxing foreign direct investment income.

12. A foreign direct investment should be defined as an investment by a Canadian resident or associated group of Canadian residents (a) in a non-resident corporation in which he or the group holds a 10 per cent or greater interest in the voting power, in the profits or in the assets distributed on liquidation of the non-resident corporation, or (b) in a foreign property or business in which he or the group holds a 10 per cent or greater interest.

13. Canadian taxpayers having foreign direct investments should report annually the foreign income earned and the foreign income taxes paid in each foreign jurisdiction. If foreign income taxes were paid at a rate of at least 30 per cent, no further Canadian tax would be payable unless or until the foreign income was received by a Canadian individual. If foreign income taxes paid on this current income were less than 30 per cent of the foreign income earned, the difference should be paid to Canada as a special tax. This procedure would ensure that all foreign source direct investment income would immediately become subject to income taxes of at least 30 per cent on an accrual basis. If the foreign income was subsequently subjected to a withholding tax in the foreign country on distribution to the Canadian investor, the special tax on such income would be refunded to the extent of the withholding tax. If a Canadian taxpayer with less than a controlling interest in a foreign direct investment could establish that he was unable to obtain sufficient information to compute the foreign income, he should be entitled to elect to be taxed as a recipient of portfolio investment income.

14. For the purpose of these computations foreign income should be defined as income reported to the foreign jurisdiction (or in an audited financial statement), subject to certain adjustments to make this figure generally comparable to income as defined for Canadian tax purposes. These adjustments would not be numerous or detailed.

15. To ease the problems of compliance it should in general be deemed that income derived from the United States and the United Kingdom had been taxed at a rate of at least 30 per cent. Therefore, since the special Canadian tax would seldom be payable, the computation of direct investment income from these two countries would not be necessary except possibly in special circumstances specified by regulations.

16. For the purpose of these computations, income taxes would be defined and would include the taxes described in the international tax agreements where applicable. However, certain other taxes might also be deemed to be income taxes. In addition, if as a matter of public policy foreign investment in specified countries was to be encouraged, income taxes could be deemed to have been paid up to a certain amount regardless of the actual amount of tax levied.

17. Dividends or other income (net of withholding taxes) received from a foreign direct investment should be deemed to have been subject to foreign tax at a rate of 30 per cent. The Canadian taxpayer (individual or corporate) should be required to bring into income the grossed-up equivalent of the dividend or other income (the amount that would have been received had the assumed tax of 30 per cent not been paid). This would be $\frac{100}{70}$ of the net dividend actually received.

18. Where the Canadian taxpayer was a corporation receiving income from foreign direct investment, no further tax would be payable at the time of receipt. On the distribution or allocation of the income to

Canadian shareholders of that corporation, credit would be granted on the grossed-up amount of the dividend or allocation for the 30 per cent foreign tax deemed to have been paid. For ease of administration, a withholding tax equal to 20 per cent of the grossed-up amount of the distribution or allocation to Canadian resident shareholders would be paid at the time of distribution or allocation in order to bring the total credit up to the 50 per cent level which would apply in the case of Canadian income and, accordingly, the net distribution or allocation would be grossed-up by the shareholder at the 50 per cent rate. If the credit exceeded the shareholder's Canadian tax liability, he would be entitled to a refund from the Canadian government.

19. Where the Canadian taxpayer receiving income from foreign direct investment was an individual, the net income after tax would be grossed-up at the 30 per cent rate and credit would be given against Canadian personal income tax for the deemed 30 per cent foreign tax paid; if the credit exceeded the shareholder's Canadian tax liability, he would be entitled to a refund from the Canadian government.

20. Canadian portfolio investors (investors who were not direct investors) should be given an option:

a) to be taxed on the same basis as direct investors as described above; or

b) to be taxed as at present with a credit only for withholding taxes paid.

21. The basic withholding tax on most payments to non-residents other than dividends should be increased from 15 per cent to 30 per cent. This withholding tax should be applied to gifts and bequests and the income portion of payments from pension plans. In addition to interest, royalties, etc., it should perhaps be applied also

to income from employment in Canada by non-residents. This 30 per cent rate might be lowered for some specific types of payments (e.g., the present exemption for interest paid to tax-exempt entities), and reduced by treaty for certain payments to specified countries.

22. As we believe that the adoption of our proposal for the integration of the corporation and personal income taxes would encourage the issuance of shares in Canada by the subsidiaries of foreign corporations, the differential withholding tax on dividends based on Canadian share ownership should be abolished. The rate of withholding tax should not be effectively increased, and consideration should be given to fixing the rate at 15 per cent and then reducing it to 10 per cent by treaty with some foreign governments in exchange for appropriate concessions with respect to the withholding taxes to be levied on some other kinds of payments. In addition, the 10 per cent rate should continue to apply to companies which qualified for such rate by the issue or sale of shares subsequent to the time the legislation relating to "degree of Canadian ownership" became effective.

23. The income of trusts, like that of corporations, that was distributable to non-residents or accumulated for their benefit should be subject to a tax of 50 per cent and the net amount distributed would be subject to a further withholding tax at the same rate as was applicable to dividends. However, the non-resident beneficiary should be entitled to elect that instead of the 50 per cent initial tax and the withholding tax, the income payable to him should be subject to tax in an amount equal to the withholding tax that would have been levied if it had been paid to him directly. Gifts and inheritances received by a trust which were distributable to non-resident beneficiaries would be subject to initial tax at the rate of 30 per cent and would not be subject to any withholding tax on distribution.

24. A withholding tax of up to 10 per cent should be imposed on payments for services that were deducted in the computation of business or property income and were not already subject to a withholding tax. These would be services rendered outside Canada, but the benefit from which was obtained in Canada. This withholding tax should be applied only to payments that were deductible for Canadian tax purposes and should not apply to amounts paid in reimbursement of expenses.

25. In certain specific cases, non-residents should be entitled to elect to be taxed as residents of Canada, reporting their world income from all sources and deducting foreign tax credits on the present basis for foreign taxes paid on income from foreign sources. This election should be available in the following cases:

   a) where a Canadian resident became non-resident and elected to be taxed as a Canadian resident for each year after the change of residence; or

   b) where the non-resident received certain specific kinds of income from Canada, including gifts, or inheritances, the income portion of pension and annuity payments and employment income.

26. The provisions relating to foreign business corporations should be repealed, effective after a period of, say, five years in the case of a public company listed on a recognized Canadian stock exchange, and effective immediately or after a short interval in the case of other corporations.

27. The provisions relating to non-resident-owned investment corporations should be withdrawn over a period of years.

ADMINISTRATION

28. Special groups should be established in the Department of Finance and

in the Department of National Revenue (or its successor) to specialize in international taxation matters so as to keep the law and its administration up to date.

29. Detailed reporting should be required with respect to international transactions between taxpayers not dealing with each other at arm's length. Special rules should be developed in the law to prevent tax avoidance through such transactions.

TAX TREATIES

30. Canada should continue to negotiate tax treaties with other countries and should also keep these treaties under review and up to date, as far as possible.

31. Canada should improve its arrangements with other countries for the exchange of information. Such information should be provided on the condition that it is available on a confidential basis to tax officials only.

32. If possible, tax treaties should provide for a tribunal consisting of a representative of each country and a third member chosen by them to resolve disputes and problems of double taxation.

REFERENCES

1/ If individuals, businesses or organizations living or operating in high tax countries had living or operating costs that were correspondingly lower than if they lived and carried on business in low tax countries, all nations would not necessarily have to provide the same public goods and services and welfare payments in order to achieve international tax neutrality. However, it is most unlikely that taxes and private expenditures are perfect substitutes, and that the taxes to finance public expenditures are equal to the costs that would be incurred in the absence of the public expenditure. Taxes are imposed to force people to bear a share of the cost burden they otherwise would not bear.

2/ If nations could agree on the "proper" division of revenues between source and destination countries, this condition could, in principle, be realized by the universal adoption of the following technique (assuming all countries had the same tax base and the same tax rates):

a) Source countries would impose tax at the top personal rate on the income of non-residents.

b) Destination countries would impose tax at full personal rates on the world income of residents.

c) Taxpayers would file a tax return reporting their world income in each source country.

d) Each source country, on the basis of the non-resident's world income, would determine the proportion of the non-resident's total tax to which it had a right and make the appropriate refund to the non-resident.

e) Destination countries would give a full tax credit for the net taxes paid to source countries.

3/ While it can be argued that Canada should reduce or eliminate its dependence on foreign saving, and hence reduce or eliminate the net

capital inflow, there can be little doubt that the elimination of the gross flows (both of investment in Canada by non-residents and of investment abroad by Canadians) would be a serious economic loss; for there are some investments in Canada that could not be profitably undertaken by Canadians, and some investments outside of Canada that are more profitable to Canadians than to other nations.

4/ Further discussion of this United States legislation is contained in Appendix L to this Volume.

5/ We have suggested that any Canadian tax due should in general only become payable when the foreign direct investment income was received by a Canadian resident individual. However, we have recommended that the Canadian tax should be payable by the corporate direct investor, even when the distribution was to a second Canadian corporation, so that all corporate distributions would be eligible for the 50 per cent gross-up and credit.

6/ $100 of corporate income less corporation tax of $50; the balance is taxed to the shareholder in the amount of $25 less a dividend tax credit of $10.

7/ Dividend of $50 ($100 of corporate income before tax) grossed-up to $100 and brought into income and taxed $50 with a credit of $50.

8/ Given no change in foreign taxes, no change in the Canadian treatment of foreign direct investment by Canadians, and the adoption of integration in Canada, $100 of before-tax corporate income would yield $50 to the Canadian shareholder (marginal rate 50 per cent) on corporate assets employed by a Canadian corporation in Canada and $29.75 on the corporate assets employed by the foreign subsidiary of a Canadian corporation. Therefore, corporate assets of $1,000 invested abroad would have to yield $168 before tax to give the Canadian shareholder the same after-tax return he would obtain if $1,000 of corporate assets earned $100 in Canada.

9/ Reverse shifting is likely to take place (to the limited extent it does take place) within the first few years following the adoption of integration. The adjustments brought about through changes in the allocation of investment are likely to involve quinquennia if not decades. There is no danger that there would be a quick and drastic move from Canadian to foreign investment by Canadians.

10/ The average rate of tax applicable to Canadian source corporate income is just under 30 per cent, but it would appear that upper income individuals receive relatively more foreign source corporate income than Canadian source corporate income.

11/ Different bases for the imposition of income tax are discussed in Sherbaniuk, Hutcheon and Brissenden, "Liability for Tax—Residence, Domicile or Citizenship?" 1963 Tax Conference Report (Canadian Tax Foundation) 315.

12/ Income Tax Act, section 139(3).

13/ Bullock v. Unit Construction Co. Ltd., [1959] 3 All E.R. 831.

14/ Section 139(4a).

15/ Section 139(1)(e).

16/ Section 139(7).

17/ Section 106(1)(b)(ii)(C).

18/ Section 63(4b).

APPENDIX A

A COPY OF THE LETTER RECEIVED BY THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS FROM ITS COMMITTEE ON ACCOUNTING AND AUDITING RESEARCH 1/

June 27, 1963

Mr. A.J. Little, F.C.A.,
Chairman,
Special Taxation Committee,
Canadian Institute of Chartered Accountants.

Dear Mr. Little:

In your letter of April 26, 1963, you asked for an expression of opinion from the Committee on Accounting and Auditing Research that would assist your Committee in its presentation to the Royal Commission on Taxation. Your specific question was whether the Income Tax Act would be improved if it were provided in Section 4 of the Act that, subject to the other provisions of the Part, income from a business or property should be determined in accordance with generally accepted accounting principles, or alternatively in accordance with generally accepted accounting practices. We considered your request at some length at a meeting of the Research Committee on May 6 and 7 and again at a Sub-committee meeting held on June 20, and the following represents the views of the majority of the members of the Committee.

Accounting is directed toward the fair measurement of income on a basis that has some historical acceptance. It must, however, remain sufficiently flexible to reflect changes in economic conditions and concepts without the restrictions of legislative or judicial pronouncements and without the inherent pressure resulting from the natural desire to minimize taxes.

On the other hand, the Income Tax Act is directed towards the measurement of income in such a way that it can be taxed. Legislated rules and judicial interpretations are bound to play an important part in determining this income. Such conditions, if linked by statutes with accounting principles and practices, could detrimentally affect their natural development.

Further, we believe that if the taxing system is to work surely and simply, the Act should be specific rather than based on a statement of general principles.

In reaching this conclusion, the Committee was influenced by the following facts:

(1) Over the history of accounting, substantial changes have occurred in recognized accounting principles and practices. The process of change is continuous and there is no reason to expect that it will not continue in the future. On the contrary, there are at present many challenges (for example, the problem of accounting for changes in the value of money) that could well lead to substantial changes in accounting principles over a period of years.

(2) Partly because of this process of change, and partly because of differences in individual circumstances and opinions, there exists at any one time some diversity in accounting practice. The diversity exists not only at the level of theory or principle, but also at the level of practical accounting methods (for example, a wide choice exists as to the method of calculating the cost of inventories).

(3) There are now, and probably will continue to be, in the income tax statutes, specific departures from recognized accounting practices to facilitate the administration of the Act, for the purposes of equity and to provide special incentives.

In spite of the above-mentioned differences and uncertainties, it is obvious that the principles governing the determination of income for taxation and accounting should not be widely apart. Accounting principles attempt to provide a fair determination of income; if the income tax is to be a tax on income and not a tax on wealth or receipts or some other base, the tax statute and, equally important, its interpretation by the administration and the courts, must conform fairly closely to proper accounting principles. Such conformity would have avoided certain past inequities such as the total disallowance of many necessary business

expenditures on the grounds that they provided a long-term benefit and therefore were capital expenditures, but at the same time were not such as qualified for capital cost allowance.

The question then is, what is the best way to obtain substantial conformity between accounting principles and the tax statute? The method under consideration is to enact that for tax purposes, subject to the specific departures set out in the Act and mentioned in point 3 above, income from a business or property shall be determined in accordance with generally accepted accounting principles or practices. If this were done, it has been suggested that many detailed sections of the Act could be discarded since they exist simply to spell out what should or should not be included in computing income. In addition, inequities, such as those mentioned in the previous paragraph, would be largely avoided.

In spite of these potential benefits, it is the opinion of the majority of the members of the Committee that the proposed change, by itself, would be largely ineffective in improving the working of the Act and would probably have some undesirable side consequences. Because of the diversity in accounting principles and the even greater diversity in accounting practices, and the changes that occur in both principles and practices over time, we think that a considerable degree of uncertainty would result from a simple provision of this nature. There would then follow a demand for the enactment of specific sections to clarify the areas of uncertainty (unless they were clarified by judicial decisions).

An important disadvantage to this process lies in its potential influence in the development of accounting principles. Where differences in accounting principles now exist, attempts can be made to resolve them on their merits. If, however, income subject to tax were to be based more directly on reported accounting income, the arguments in favour of the most conservative of the possible accounting treatments would be powerfully reinforced. The total effect of these tendencies, together with judicial

pronouncements as to what are accounting principles or practices, might well be prejudicial to the future development of accounting.

In short, it is the Committee's view that any advantage from this possible change in the Income Tax Act would be more than offset by the difficulties in its application and the potential dangers to the future development of the accounting art. In our view, improvement in the Act must come from a careful and detailed redrafting of the Act. Those responsible for redrafting the Act must keep in view the overriding objectives of a fair and workable determination of taxable income. In this they should be guided by the best accounting practices. However, in the opinion of the Committee it would not be satisfactory merely to amend the Act to incorporate a reference either to generally accepted accounting principles or to generally accepted accounting practices.

Yours very truly,

(Signed) J.R. Church, F.C.A.,
Chairman,
Committee on Accounting and
Auditing Research.

REFERENCE

1/ This letter is referred to in Chapter II of the Submission by the Canadian Institute of Chartered Accountants to the Commission.

APPENDIX B

THE FOREIGN TAXATION OF TRUST INCOME

United Kingdom

Trustees are taxable as "the persons receiving or entitled to receive the income from the trust corpus", and the standard rate of tax is payable. Trustees are not generally liable for surtax and are not entitled to personal allowances, these being claimed by the beneficiary. Trustees are not taxable on foreign income if the beneficiary would not have been taxed had he received the income directly. There is no gift tax in the United Kingdom, so *inter vivos* settlements or gifts in trust are not taxed. Estates held in trust will have borne estate tax.

Income which is distributable and income which is to be accumulated are both subject to the standard rate of tax, which is usually paid by the trustee, although it may be assessed directly to the beneficiary. When the beneficiary receives income, the payment is treated as having already borne the standard rate of tax and is grossed-up at the standard rate and included in the beneficiary's income. Personal allowances and surtax are computed on the grossed-up total income.

The treatment of income which is accumulated in the trust is more complex than the treatment of income which is distributed currently. Accumulated income which is vested, that is, which the beneficiary is entitled to claim as it arises, but which he either does not claim or cannot claim because, being an infant, he cannot give a good receipt, is treated as the beneficiary's income. If the beneficiary has only a contingent interest in income, that is, if he is not entitled to the income when it arises, but only at some later date, the income is taxable on receipt by the trustee at the standard rate of tax, but is not subject to surtax. The income then becomes capital and the beneficiary, on becoming entitled to it, receives it as such. There is, however, a special provision which enables a beneficiary whose interest was contingent on age or marriage to claim back

his personal reliefs over the period of accumulation, but this does not make it his income for surtax purposes over that period.

The treatment of income from an estate under administration is governed by other rules which have much the same effect, namely, that a beneficiary is treated as having an aliquot share in the income arising during the administration on which he is taxable, but here he would have to pay surtax. Distributions from limited interests, such as life interests, are grossed-up for income tax on a provisional basis, but when the administration is complete, the income received is allocated over the period and any appropriate adjustments are made.

An annuity received by a beneficiary is income, whether it is paid out of income or capital of the trust. Other income interests are, in general, treated on the "conduit" principle according to which the source of the payment governs its treatment in the hands of the beneficiary.

The United Kingdom legislation has complex provisions to prevent tax avoidance by the use of transfers of income or property, including transfers in trust, which are technically also referred to as "dispositions" and "settlements". The general method is to treat the income transferred, or the income from the transferred property, as the income of the transferor. The results vary. Sometimes it is only surtax which the transferor must pay, and sometimes it is the standard tax as well. In some cases, particularly where the transferor does not personally benefit, the burden of the increased tax is on the transferee. This method of preventing avoidance of the progressive features of the rate structure by the "attribution of income" is also to be found in the taxing statutes of Canada and the United States.

United States

In the United States, the taxation of trusts, both inter vivos and testamentary, is essentially the same as in Canada, that is, the trust is

taxed on its income in the same manner as an individual, but with provision for the deduction of income which is distributable to beneficiaries. Such income is taxable to the beneficiary, but treated under the conduit principle as if received by the beneficiary directly. Thus, it has the same tax character in his hands as it had when received by the trust. For example, if the trust receives tax-exempt interest which is distributable, it will be regarded as tax-exempt interest as respects the beneficiary. In general, the treatment of estates is the same. The trustee or executor files a fiduciary return and pays the tax due. The return provides for a schedule of the beneficiaries and for the amounts payable to each.

An estate is entitled to a personal deduction of $600, but a trust is entitled only to a limited personal exemption of $300 if all income is distributable currently, or $100 otherwise. Estates and trusts are also entitled to deductions for net operating losses and for depreciation and depletion. Depreciation allowances are apportioned as provided in the trust instrument, or, if there are no such provisions, on the basis of the allocation of the trust income. Credits for partially tax-exempt interest and foreign tax, and an unlimited deduction for payments to charity, are also allowed.

Under the concept of "distributable net income", a beneficiary will not be taxed on more than he receives or is entitled to receive but may be taxed on less. Any distribution in excess of distributable net income is treated as a distribution of corpus, both in determining the amount taxable to the beneficiary and the amount deductible by the trust. Generally, "distributable net income" is equal to the taxable income of the trust, but there are statutory adjustments. For example, to give a beneficiary the advantage of tax-exempt income, thus preserving the conduit principle, tax-exempt interest is added to distributable net income. Capital gains are generally excluded from distributable net income except to the extent that they may be distributable to the beneficiary in the year. For simple

trusts, extraordinary dividends and taxable stock dividends are also excluded if allocated bona fide by the trustee to the trust corpus. Deductible expenses are deducted entirely from distributable net income, even though under trust law a part of the expense, for example, the trustee's fees for taking care of the principal, would be charged against the corpus.

A distinction is made between simple trusts, in which all the income is currently distributable, and discretionary or complex trusts, in which there may be distributions of accumulated income and of the corpus of the trust as well. There are special statutory provisions to settle how much of the aggregate distributable net income should be attributed to each beneficiary where the distributions exceed distributable net income, and the trustee has discretion in the distribution 1/.

The system is known as the "tier" system, and it determines the priority on which aggregate distributable net income of the trust for the year is allocated against the actual distributions made under the trust instrument or trust law. The general principle is that distributable net income is allocated, first, to amounts which are considered income by the law of the trust, such as interest and dividends, and which are required to be distributed currently, whether distributed or not, and are thus taxed to the beneficiaries as gross income (first tier). If these first-tier amounts are equal to or exceed the distributable net income for the year, then any other distributions will not be added to the beneficiaries' gross income, except where the throwback rule, discussed below, applies. If first-tier amounts are less than the distributable net income as defined, then second-tier amounts are required to be added to a beneficiary's gross income for the year up to the beneficiary's share of the distributable net income remaining after allocation to the first tier. Second-tier amounts are any amounts in excess of first-tier amounts which are "paid, credited or required to be distributed" to the beneficiary, such as current income which the trustee has discretion to distribute or accumulate, accumulated income

and corpus other than specific bequests. Substantially separate and independent shares of different beneficiaries in the trust are treated as separate trusts in determining distributable net income of the trust to prevent unfair allocations of distributable net income, as where one beneficiary receives distributions of part of the current income plus corpus, and the balance of current income is accumulated for another beneficiary.

In addition, the Internal Revenue Code contains special provisions to prevent tax minimization by the accumulation of income in a trust when the tax rate of the trust is less than that of the beneficiaries, followed by the distribution of it in a subsequent year free of tax. The provisions apply only to complex trusts and not to estates under administration. In essence, where a distribution is made from income accumulated within the preceding five years, it is taxable to the beneficiary. But, if the beneficiary chooses (as he usually will), the tax payable on the accumulation distribution is determined as if the beneficiary had received it in the year it was received by the trust. The beneficiary is given credit against his tax liability for taxes which have been paid by the trust on this accumulated income. There are a number of exceptions to this "five-year throwback rule", for example, income accumulated until the beneficiary reaches 21.

The use of multiple trusts has given rise to an avoidance problem which is still being tested by litigation. Proposals made to Congress in 1960 to solve the multiple trust problem along the lines of section 63(2) of the Canadian Income Tax Act were not adopted.

The United States has also found it necessary to prevent tax avoidance by the making of a gift to a trust in which the grantor retains some benefit or advantage. There is now a set of rules in the Internal Revenue Code and the Regulations which attributes the income of the trust to the grantor where any of the following situations applies:

1. The grantor retains an interest in the income of the trust.

2. The corpus of the trust may revert to the grantor within 10 years.

3. The grantor retains, or vests in a non-adverse party, the power to control the beneficial enjoyment of the trust.

4. The grantor retains certain self-serving administrative powers over the trust.

5. The grantor retains the power to revoke the trust.

6. The trust income may be applied to pay premiums on insurance on the life of the grantor.

7. The trust income is actually used to discharge a legal obligation of the grantor for support 2/.

REFERENCES

1/ The provisions, which are contained in sections 661 and 663 of the Internal Revenue Code, are quite complex and provide for the treatment of a variety of items. The description in the text must be taken as a very general summary.

2/ It should be noted that the discussion above deals only with income tax consequences. The results for estate and gift taxes may be different. For an excellent discussion of these problems, see Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax, Washington: United States Government Printing Office, 1947.

APPENDIX C

BUSINESS TRUSTS

The business trust, which we refer to in Chapter 21 as a unit holders' trust, is a form of organization that lies somewhere between the partnership and the corporation and has certain attributes of each. Legally it is a trust, but the very flexibility of the trust form permits it to be adapted to many situations and to imitate other types of organization. This form of organization was widely used in England up to the passage of the early Companies Acts in the nineteenth century, and went under the name of a joint stock company. After 1880, it was infrequently used in England until it was revived in 1930 as the modern unit trust. Today the unit trust is widely employed in many areas of British business.

On this side of the Atlantic, the business trust found great favour in the United States, and especially in Massachusetts, in the early part of this century. It was used at first primarily to avoid the stigma attached to corporations. Because of the widespread use made of it in Massachusetts as a medium for developing real estate, it has been called the "Massachusetts" trust. A good deal of jurisprudence exists in the United States on the legal incidents attaching to this form of organization.

In Canada this type of arrangement has been bypassed in favour of the corporation. It is fair to say that, in general, it is unknown and untried except for use in investment trusts, oil and gas development and real estate, especially among small private groups. Recently the business trust has acquired some popularity as a method of avoiding the associated-corporation provisions of the Income Tax Act.

In the United States, on the contrary, the business trust has been used to operate oil wells, gas stations, laundry businesses, mercantile agencies, distributing companies, real estate development projects, motion picture productions and a myriad of other businesses.

General Legal Incidents of Business Trusts

Unlike a corporation, a trust as such does not have a separate legal personality. The general view of the nature of a trust is stated in the following excerpt from a Massachusetts case:

> "Speaking generally a trust is not a legal personality. With the exception later to be dealt with [a statute], it cannot be sued. It is represented by the trustee. He embodies it. He holds title. He deals with the property in which trust rights exist.
>
> "Contracts with regard to the rights and property affected by trusts are the contracts of the trustee. He, in person, is liable upon them. He is not acting as representative or agent of another. He is acting for himself, but with fiduciary obligations to others." 1/

A business trust differs somewhat from an ordinary trust. It may be said that the most basic, and indeed the essential, difference is that it has for its main purpose the conduct and carrying on of business. It is in this regard a very flexible kind of organization because it may be created for any purpose for which a contract may be made.

A workable definition of a business trust has been stated in these terms:

> "It is a combination of capital vested in trustees who issue transferable certificates for shares and execute a declaration of trust designed to provide for the shareholders all the immunities of corporate shareholding." 2/

There is in this definition the same essential characteristics which are found in any trust, namely, a settlor, a trustee, a beneficiary and trust property.

It has been said that a business trust lies somewhere between a partnership and a corporation and displays characteristics of each. But the prevailing attitude now in United States and British law is that the business trust is sui generis, and that it is to be dealt with in law as a separate legal concept that is distinct from a partnership and a corporation.

A tabulation of differences between the business trust and the corporation will highlight some of the principal legal features of a business trust:

	Corporation	Business Trust
1.	Owes its existence to statute.	Owes its existence to the law of equity.
2.	Created by authority of the government by a charter, letters patent, or memorandum of association.	Created by agreement.
3.	Is a separate legal entity.	Is not a legal entity.
4.	Corporation shareholders exist as a body mutually bound by the corporate rules and with powers to collectively control the company.	A trust estate consists simply of property without human elements. Equitable title to the estate is held by beneficiaries bearing no contractual relation, one with another. They may or may not have power to direct the trustee.
5.	Shareholders have limited liability created by statute.	Limited liability of a trustee may only be obtained through proper notice to creditors.
6.	Directors deal with corporate funds and property as agents.	Trustees deal with trust estate as fiduciaries subject to equitable obligation to account.
7.	Directors are not personally liable for their acts on behalf of the company, with certain exceptions created by statute or the corporate charter or by-laws.	A trustee is personally liable for his acts as trustee except as he may be relieved of liability by the trust instrument.

Some of the tests for distinguishing between partnerships and business trusts which have been developed in the United States are stated below in summary form:

1. Sharing Profits. Mere sharing of profits is not a conclusive test of partnership. The courts will look to the provision for distribution of losses and other provisions of the trust instrument to determine whether the parties intended to become partners.

2. Control Test. The control test refers to the manner in which the business is to be conducted and the repository of the ultimate power of control over the affairs and property of the trust. If, under the trust agreement, the trustees have complete title to the property with exclusive right to manage the business and affairs of the trust, free

from the control of the beneficial owners, the organization is treated as a business trust. If, on the other hand, the beneficial owners exercise or have power to exercise control, the organization is treated as a partnership.

The courts have said that they look to the trust instrument to determine whether control exists. In other words, a de facto test is not applied. The control must be found within the four corners of the trust instrument. It is interesting to note some powers which have been retained without creating a partnership. For example, it has been held that the power to amend or terminate a trust, but only with the consent of the beneficiaries, does not convert the organization to a partnership. It has also been said that where trustees have complete freedom of judgment, the bare power of the beneficiaries to remove them does not create a partnership. On the other hand, the power to amend the trust, remove trustees, appoint other trustees, fill vacancies, terminate the trust, hold regular meetings, and amend by-laws and regulations have been held to be sufficient control by beneficiaries to create a partnership.

The control test may be likened to the right of the beneficiary of a personal trust to call for the termination of the trust, in which case the trust property would be regarded as belonging to him in equity. This would be the case when the beneficiary was of full legal competence and the trustee had no powers of management or discretion. In these circumstances, the court would, on application, terminate the trust and direct the property to be transferred to the beneficiary.

The Use of Business Trusts

It may be asked why taxpayers would use a business trust when incorporation was available. There are a number of advantages which may be derived from the use of business trusts. These advantages can be summarized conveniently as follows:

1. Minimal regulation by government and freedom from corporate taxation, Laws relating to security issues, the doctrine of ultra vires, complicated and involved accounting procedures, annual reporting, and business registration frequently do not apply to a business trust.

2. Freedom of members from personal liability such as is imposed on partners. In the United States, it has been held that this freedom from liability depends primarily on the degree of control which the beneficiaries may exercise over the trustees.

3. Continuity of existence in that the trust does not dissolve as does a partnership upon the transfer of a share or upon the death, insanity, or bankruptcy of a member.

4. Lower costs of organization.

On the other hand, certain disadvantages attach to the business trust and may be summarized as follows:

1. Possible liability of the beneficiaries for the debts and torts of the trust. As already noted, this liability may depend in large measure on the degree of control which the beneficiaries exercise over the trustees.

2. Uncertainty of the legal rights and liabilities created by a business trust. In Canada, there is virtually no law dealing specifically with this type of organization, so that many questions involving the rights, duties, liabilities, or immunities of the trustees, the beneficiaries and third parties are unanswered.

Why has the business trust form of organization not found the same favour in Canada as it has in other countries? Possibly this is because of a preoccupation with the notion of "incorporation", the relative ease of incorporation, and the lack of any specific impetus to the use of trusts such as led to the development of the Massachusetts trust. Whatever the reasons

may be, it is clear that in Canada the law is not well developed in this area. There are, of course, general principles of trust law which have been worked out and accepted for many years. The development of new concepts related specifically to business trusts would probably require Canadian courts to draw on English and United States experience.

It would appear probable that the business trust will not become a major form of organization in Canada. Nevertheless, because of its flexibility of form, if any substantial tax advantage was available to business trusts, many enterprises now operated by partnerships and corporations could be carried on by business trusts.

REFERENCES

1/ Larson v. Sylvester, (1933), 185 N.E. 44, pp. 45-46. See also Smith v. Anderson, (1880), 15 Ch. D. 247.

2/ S.R. Wrightington, "Voluntary Associations in Massachusetts", (1911-12) 21 Yale Law Journal 311.

APPENDIX D

A MAJOR WEAKNESS OF THE PRESENT SYSTEM OF TAXING CORPORATIONS—"SURPLUS-STRIPPING"

Under the present method of taxing corporate source income in Canada, with certain exceptions, no personal tax is levied on such income until it is distributed, or deemed to be distributed, to resident individual shareholders or to non-residents. However, the undistributed corporate income carries with it a potential liability to personal tax at such time as it may be distributed. In widely held corporations it is relatively easy for shareholders to realize a tax-free benefit of at least some proportion of the undistributed income by the simple expedient of selling shares. The sale of shares also transfers to the purchaser the potential liability to personal tax associated with the undistributed income, but the significance of this liability is usually discounted because the tax can be deferred.

The prices at which shares of widely held corporations sell in the open market are determined by the interaction of many factors and of many buyers and sellers. The value of the underlying assets representing the undistributed income and the potential tax liability associated with that undistributed income are only two of the factors, and they, in many instances, will be outweighed by other factors as determinants of price. The potential tax liability associated with the undistributed income will vary as between buyers and sellers. At the extremes, one of the parties to the transaction might have a marginal tax rate of 80 per cent, or 60 per cent after allowing for the dividend tax credit, whereas the other might not be subject to tax on receipt of a dividend. In normal situations it must be assumed that the market price does not reflect the relative tax positions of individual purchasers and sellers but rather some composite effect. It is apparent, however, that where a distribution of corporate income was to be made, a shareholder who was subject to a very low rate of tax, or one who was not subject to any tax on receipt of Canadian dividend income, would retain more of the dividend after tax than a shareholder who was subject to high rates of tax. If, prior to the distribution of any substantial

amount of corporate income, the latter shareholder sold his shares at a price which reflected most of the undistributed corporate income, he would benefit to the extent of most of the personal income tax he might otherwise have paid 1/. If the purchaser was not subject to tax on receipt of Canadian dividend income, he would also benefit to the extent that the amount of the distribution was not fully reflected in the purchase price. Such complete mutuality of interest between purchaser and seller, combined with a substantial distribution of corporate income, is rare in the case of widely held corporations but, where it does arise, 2/ both purchaser and seller gain by the type of sale previously described, and the potential tax liability on distribution substantially or completely disappears. It is easy to imagine that the shareholders of a closely held corporation, heavy with undistributed income and facing liquidation, would have every incentive to seek a purchaser who could receive the corporation's liquidating distribution free of tax. A sale could then be arranged at a mutually profitable price, the shared profit being realized from the reduction in the tax liability that would have arisen had the distribution been made to the selling shareholders.

Where a substantial corporate distribution is known to be imminent and a shareholder has no good reason to retain his interest in the company, it is normal that he should wish to sell his shares to another party whose tax circumstances are such that a mutual benefit can result. Where this is done for the purpose of reducing the tax liability, the action taken may be regarded as tax avoidance.

It was inevitable that some shareholders would seek to achieve the same tax saving while retaining control of the corporation, or retaining control of the business carried on by the corporation. In effect, they sought to arrange a tax-free distribution from a continuing business which, if made in the normal manner, would have been a taxable dividend. To this end, various schemes were contrived or arrangements entered into in such a

way that the shareholders would receive in non-taxable form what were in effect distributions of income 3/.

These tax avoidance practices became known as "surplus-stripping". This term is not capable of precise definition, and the dividing line between surplus-stripping and sophisticated tax planning is a very narrow one. In January 1963, the Minister of National Revenue stated:

> "There is no specific definition of the term 'surplus strips'. It is frequently used to refer to any procedures that have been followed for the purpose of transferring surpluses from corporations to their shareholders with a minimum of tax payment." 4/

Obviously, this very general description could be interpreted to include procedures which were provided for in the Income Tax Act and which would not be considered surplus-stripping by either the taxpayer or the Department of National Revenue, for example, the use of an election under section 105. In the bulk of surplus-stripping schemes, sales or redemptions of shares are made in such a way that some part of the non-taxable proceeds is, in essence, a disguised dividend. The definitional difficulty is in distinguishing a normal sale from a sale which is part of a contrived scheme, particularly as the schemes assume a multiplicity of forms depending on circumstances peculiar to the corporation and its shareholders. It is not necessary to describe the many methods by which undistributed income could be extracted with minimal or no tax cost, for they have been the subject of many articles and speeches over the past few years.

Tax avoidance of this nature is not peculiar to the Canadian tax system but is common to all tax systems that do not tax capital gains, or tax them at low rates, and that impose a tax on corporate distributions which is payable at the time of distribution. The succeeding sections of this appendix review the history of the Canadian anti-avoidance legislation, and the anti-avoidance legislation adopted by some other countries faced with the same problem.

CANADIAN LEGISLATION TO PREVENT SURPLUS-STRIPPING

Because Canadian income tax legislation was completely redrafted with effect from January 1, 1949, it is convenient to review surplus-stripping legislation prior to that date separately from that in effect subsequently.

Pre-1949 Legislation

By 1924, the intention that corporate income should be subject to personal tax on ultimate distribution had been clearly established. The exemption from income tax of intercorporate dividends which was introduced in 1926 would, in the absence of preventive legislation, have provided an easy means whereby the corporate assets representing its undistributed income could have been made available to the shareholders tax free. In its simplest form, this result could have been achieved by selling all the shares of the corporation with undistributed income to a second corporation owned by the same shareholders for a price that included the value of the underlying assets representing the undistributed income. Cash, or other liquid assets, could have been transferred from the first to the second corporation as a tax-exempt intercorporate dividend and then paid to the original shareholders in partial satisfaction of the liability to them in respect of the purchase price of the shares in the original corporation. To prevent this, the 1926 legislation provided that shareholders selling shares in those circumstances would be taxable on the intercorporate dividend as if it had been received by them. In the same year, further anti-avoidance legislation relating to corporate distributions was enacted to prevent the distribution of capital without first distributing, or at least paying tax on, undistributed income, and to deem that certain transactions should result in dividends to the extent of the corporation's undistributed income. Such transactions included certain advances or loans to shareholders, the payment of a premium on redemption of shares and the declaration of stock dividends.

By 1936, it was found necessary to strengthen still further that part of the 1926 legislation that was designed to prevent tax avoidance by the sale of shares and the utilization of tax-free intercorporate dividends, but this also proved to be inadequate. The struggle to prevent the tax-free extraction of undistributed income in the pre-1949 period culminated in the enactment in 1938 of section 32A of the Income War Tax Act. Section 32A vested in the Treasury Board the power to direct the tax consequences of transactions in those cases where it was felt that the main purpose of the transaction was the reduction or avoidance of taxes. As finally amended, it contained one subsection couched in such general terms as to apply to any tax-motivated transaction and this provision, in somewhat modified form, continues in the present Act as section 138. The powers conferred by it were never exercised after 1949 and it came to be regarded by sophisticated taxpayers and their advisers as something of a "paper tiger". Two of the subsections of section 32A that were added in 1943 and were more specifically directed at surplus-stripping were not carried forward into the new Act. One of those subsections was aimed at a specific set of circumstances but the other, couched in broad terms, was directed at payments or benefits received directly or indirectly from a corporation having undistributed income on hand. Although section 32A gave sweeping powers to the Treasury Board it also contained a provision to the effect that, on appeal from an assessment made pursuant to these powers, the Exchequer Court of Canada had jurisdiction to determine whether the main purpose of the transactions was tax avoidance.

Post-1948 Legislation

The introduction of the Income Tax Act in 1948 resulted in major changes in tax legislation, including the elimination of most ministerial discretion. Those subsections of section 32A directed specifically at surplus-stripping and certain other sections dealing with that subject were withdrawn and subsequently replaced by the new concept of "designated surplus". In general

terms, the new legislation provided that where one corporation acquired control of another at a time when the acquired corporation had undistributed income on hand, such undistributed income would become "designated surplus", and that dividends paid out of this surplus would not be exempt from tax in the hands of the controlling corporation. The prohibitive tax that would ordinarily result from applying normal corporation tax rates to such a dividend indicates that the legislation was intended to prevent avoidance rather than raise revenue.

As taxpayers sought and found means to circumvent these provisions, the periodic introduction of amendments directed at specific schemes was resumed. In 1955, legislation was introduced to deal with the situation where the dividend paid from designated surplus was received by a non-resident corporation, by exempt persons or by traders or dealers in securities 5/. Because, in most cases, those recipients of a dividend paid from designated surplus would pay little or no tax thereon, the legislation imposed a special tax on the paying corporation. The rate of tax is nominally 20 per cent in the case of a dividend paid by a corporation controlled by a dealer in securities and 15 per cent in the case of the other described persons, but because the tax payable reduces the paying corporation's undistributed income, the effective rates of tax on the amount of designated surplus can be reduced to 16.66 per cent and 13.05 per cent respectively. The enactment in 1958 of a provision to deal with statutory amalgamations 6/ opened another major break in the already vulnerable wall of legislation constructed to prevent surplus-stripping. In 1959, further legislation was enacted to buttress the designated surplus concept where a statutory amalgamation has taken place 7/. In general terms, it imposed a flat rate of tax, in this case 20 per cent, on the amount of undistributed income of the predecessor corporations which was not represented by net assets of the new corporation formed as a consequence of the amalgamation. This legislation was amended in 1960, but has continued to be relatively ineffective, mainly because of deficiencies in the provisions.

In addition to those more obvious weaknesses, the definition of designated surplus was in itself susceptible of circumvention. Without entering into a detailed technical discussion, it can be said that two of the vulnerable points concerned the definition of control and the definition of the amount of undistributed income that was to be "designated". Given the existing flexibility of corporate and intercorporate organization and reorganization, it appeared possible to avoid the intent of the legislation by intelligent planning, or, failing that, by subsequent reorganization of capital structures or intercorporate relationships. The efficacy of this legislation may be judged from the fact that the practice of surplus-stripping became widespread.

The legislative response to this obvious avoidance of the intent of the statute came in 1963 with the introduction of section 138A. The major portion of this section is addressed to the problem of surplus-stripping and, in general terms, it provides that where an amount has been received by a taxpayer as consideration for the sale or other disposition of shares, or in consequence of a corporation having redeemed, acquired, reduced, or converted its capital stock, or as exempt income, the Minister can direct that all or part of the amount be included in the taxpayer's income if, in his opinion, it was received as part of a surplus-stripping scheme. As a safeguard, the section allows the taxpayer to take an appeal against the direction to the Tax Appeal Board or the Exchequer Court. The tribunal may confirm or vary the direction, or, if it determines that none of the purposes of the transaction or series of transactions was to strip surplus, it may vacate the direction.

There is a striking similarity in the history of the legislation to prevent surplus-stripping in the two periods. In each case, attempts were made originally to enact legislation that detailed the then known methods of surplus-stripping and detailed the tax consequences of using the particular method. In each case, the attempts failed and the subsequent amendments

to extend or strengthen the legislation were equally unsuccessful, until, ultimately, resort was had to discretionary legislation. In the pre-1949 period the discretionary power was vested in the Treasury Board, whereas in the subsequent period it was vested in the Minister of National Revenue. In each case the taxpayer was given protection in that the courts were given jurisdiction to review the exercise of the discretionary power.

The Effects of Canadian Legislation to Prevent Surplus-Stripping

Section 138A(1). The enactment of section 138A(1), granting certain discretionary power to the Minister of National Revenue to deal with this particular form of tax avoidance, has undoubtedly inhibited the practice to a very substantial degree and may have halted it completely. Insufficient time has elapsed to establish whether taxpayer ingenuity will find a means of surmounting this most recent and formidable barrier against the tax-free extraction of undistributed corporate income, but, if past history is any guide, attempts will probably be made. The efficacy of this legislation is primarily dependent on whether the conditions precedent to the exercise of ministerial discretion are sufficiently broadly drawn to cover all possible surplus-stripping schemes. This we have reason to doubt, but where an omission is discovered or anticipated, prompt legislative action to bring it within the scope of the section should be adequate to restore its potency. To a considerable extent, the efficacy of this legislation will also depend on how assiduously the Minister makes use of this section and on the breadth of interpretation given to its provisions by the courts when taxpayer appeals are made from directions by the Minister.

Section 138A(1) reflects Parliament's decision that, at least as a temporary measure pending a better solution, it will not attempt to specify precisely all the transactions which are subject to tax in a very broad area but instead will empower the Minister to do so. Basically, the Minister is empowered to collect tax which he believes has been avoided

through technicalities. Uncertainty must exist, therefore, until the Minister decides and issues an assessment, which he can do until a day four years after the date of issue of the original assessment for the year in which the taxpayer received "an amount" considered taxable under this section. Such decisions can be extremely difficult, because the Minister ordinarily cannot see beyond the currently completed or proposed transactions. In cases where the intentions of taxpayers as to future transactions are obscure, the Minister quite naturally might be reluctant to give an advance ruling, simply because he is unable to determine the real purposes of the transactions.

Section 138A(1) stipulates that certain factual conditions must exist before the Minister can use his discretion. A taxpayer must have received "an amount", which has a wide meaning under the Act, as consideration arising out of, or in consequence of, specified transactions. If an amount of this kind has been received, the Minister can add all or part of the amount to the taxpayer's income if he believes that one of the purposes of the transaction or transactions was surplus-stripping. The section could operate to tax persons who had no thought of carrying out a surplus-stripping operation, 8/ and could apply to transactions not normally visualized as surplus-stripping. Plainly, the scope of the section cannot be determined with certainty from its wording and there is no provision in the present law to require the Department to give an advance ruling 9/. However, officials of the Department have indicated that the section will not be applied to transactions where all the undistributed income extracted or capable of being extracted from the corporation is subjected to tax under section 105 or under some other provision. It is also understood that the Department will give non-binding opinions favourable to the taxpayer in cases where there is a transaction at arm's length and the Department is satisfied that the transaction is bona fide and that none of its purposes is surplus-stripping. In most other cases the Department has been unwilling to give a favourable ruling.

Taxpayers and practitioners have expressed great concern over this extension of ministerial discretion and the uncertainty that accompanies it. The legislation has had an inhibiting effect on many transactions which have not generally been regarded as surplus-stripping. It must be considered, for example, in every case in which a corporation purchases a substantial interest in the shares of another corporation. In such a case, the vendor of the shares may be subject to the risk of taxation by reason of some action subsequently taken by the purchaser over which he has no control. Thus, uncertainty as to the tax consequences of a transaction arises from lack of knowledge of both what practices will be regarded as surplus-stripping and what course of conduct another party may pursue.

Further uncertainty exists because, even if section 138A(1) is applied, the taxpayer has no assurance that some other section of the Act will not be subsequently applied to tax the same undistributed income. This could be the case when it is eventually distributed. That no attempt was made by Parliament to integrate the provisions of section 138A(1) with the remainder of the Act reflects the temporary stop-gap nature of the measure.

Although section 138A(1) was enacted as the ultimate weapon, the other legislation directed at surplus-stripping is still in force and certain of its effects will be considered in the ensuing paragraphs under separate captions.

<u>The Choice of Multiple Tax Rates on Withdrawal of Undistributed Income</u>. As we have stated, as early as 1924 it was intended to tax corporate income at personal rates on ultimate distribution. Certain provisions of section 105 have substantially diminished the progressiveness of the tax levied on the distribution of corporate income. A consequence of certain of the anti-avoidance provisions previously discussed is that they have provided means of withdrawing corporate income on payment by the corporation of a variety of flat rates of tax. To some shareholders, although not all, these rates are substantially less than would be paid if normal dividends were distributed

and are more attractive than even the effective rates obtainable through the use of those provisions of section 105 dealing with post-1949 corporate income. Table D-1 illustrates the comparative tax costs of extracting corporate income by certain specified methods 10/.

TABLE D-1

THE COMPARATIVE TAX COST OF WITHDRAWING CORPORATE INCOME NET OF NORMAL CORPORATION INCOME TAX
(all figures in percentages)

		Tax Cost on Marginal Dollar a/			
		Section 105 b/	Section 105B		Section 105C
Shareholder's Marginal Tax Rate (1)	Cash Dividend (2)	(3)	Dealer in Securities (4)	Tax-Exempt Persons (5)	Amalgamations c/ (6)
0	-	7.5	16.66	13.05	20
20	-	7.5	16.66	13.05	20
40	20	17.5	16.66	13.05	20
60	40	27.5	16.66	13.05	20
80	60	37.5	16.66	13.05	20

a/ In addition to the tax cost, certain transaction costs would be incurred in the procedures contemplated under columns 3, 4, 5 and 6. However, where any substantial amount of undistributed income is concerned, the only such costs which would be a material factor would be the profit allowed to the dealer in securities or to the tax-exempt person in the cases of columns 4 and 5 respectively.

b/ One half of the distribution is taxed as a cash dividend and the other half at 15 per cent.

c/ This tax would not ordinarily be applicable to the amount distributed, but rather to the amount by which undistributed income ceased to be represented by tangible net assets. See also the following section for a description of an anomaly resulting from the provisions of section 105C.

It is an interesting commentary on sections 105B and 105C, which presumably were enacted to thwart tax avoidance, that their use is beneficial to certain taxpayers, and that the comparatively low flat-rate tax resulting from their application has come to be used by certain taxpayers as an argument,

based on both "equity" and acceptability to the government, in support of proposals that dividend income should be excluded from the personal progressive tax rate structure and subjected to a modest flat rate of tax.

Designated Surplus. As we have seen, the designated surplus concept proved to be an unsuccessful means of preventing surplus-stripping although it may well have prevented certain taxpayers from engaging in the practice. Unfortunately, its provisions can also ensnare taxpayers who have no intention of surplus-stripping and whose lack of such an intention is, in some cases, apparent from the nature of the transaction. Where one corporation acquires all or substantially all of the shares of another corporation, either widely or closely held, by the issuance of its own common shares can it be said that this is part of a surplus-stripping operation? It is true that if the acquired corporation is closely held and the acquiring corporation is widely held and its shares actively traded, the previous shareholders of the acquired corporation now own a liquid asset and can in effect realize some portion of the acquired corporation's undistributed income in the same manner as any other shareholder of a widely held corporation. But is this surplus-stripping? The combined undistributed income remains intact, is represented by the same assets, and if distributed will be subject to taxation. It may well be advantageous for the operations of the two corporations to be merged, but the subsidiary cannot be liquidated into the parent without substantial tax cost. As a consequence, many such subsidiary corporations exist as shells only. Their operations and assets have been taken over, by somewhat artificial means, by the parent, and the only reason for their continued existence, until such time as the designated surplus is completely eroded, 11/ is to preserve the legal fiction that no distribution of the designated surplus has been made to the parent corporation. In this and other situations, the somewhat indirect approach 12/ of the designated surplus concept has interfered with normal and very often desirable corporate reorganization while at the same time failing in its principal purpose.

It has been suggested that the designated surplus concept puts non-resident corporations in an advantageous position as compared with resident corporations when competing for the acquisition of a Canadian corporation which has a substantial surplus. In the event that the acquired corporation was to continue its operation in its present form and not to make distributions in excess of current earnings, the complaint would not be valid because no immediate tax on the surplus would be incurred by either party. However, in the event that the acquired corporation was to be wound up, the tax cost could be 26.1 per cent of the surplus for the non-resident corporation, 13/ and 50 per cent of the surplus for the resident corporation 14/. But it is not likely that the resident corporation would submit to the 50 per cent tax. Instead, one of the other methods of distribution for which provision is made in the Act would probably be used so that the tax cost would be less than that of the non-resident corporation.

Anomalies Resulting from Canadian Legislation
to Prevent Surplus-Stripping

Although a number of those sections of the Income Tax Act that are directed at preventing the tax-free extraction of corporate income result in anomalies, we believe that only two of the anomalies are sufficiently significant to warrant mention in this appendix.

It has been stated earlier that the immunity from tax granted to intercorporate dividends is withdrawn where the dividend is deemed to be paid from designated surplus. A dividend is not deemed to be paid from designated surplus if the "control period earnings" 15/ are such that the dividend could have been paid from them. The rules for computing control period earnings make no provision for the deduction of provincial income taxes paid, charitable donations made or losses sustained after control was acquired. As a result, the aggregate intercorporate dividends that may flow tax-free can exceed the aggregate net after-tax earnings of the controlled corporation subsequent to control having been acquired with a

consequent erosion of designated surplus. As the share of the corporation income tax going to the provinces has increased, the omission of any provision for deducting provincial income taxes from control period earnings has become more significant.

The second anomaly concerns the computation of the base for the tax imposed by section 105C on any amount of undistributed income deemed to be distributed as a result of the amalgamation of corporations. The general policy followed in the Act is that distributions to shareholders are deemed to be made first from undistributed income, and only when that is exhausted is it possible to make tax-free distributions from capital gains or by way of return of capital. Under the provisions of section 105C it is possible to distribute assets of the newly created amalgamated corporation without incurring tax, thereby achieving the effective tax-free distribution of capital gains and the repayment of capital prior to the distribution of undistributed income.

FOREIGN LEGISLATION RELATING TO "SURPLUS-STRIPPING"

A review of the legislation of certain selected foreign countries whose tax systems permit a similar suspension of income within the corporate form indicates a variety of approaches to the problem.

France, Germany and The Netherlands impose special taxes on gains on disposal of shares in corporations in which the taxpayer owns a substantial interest. Generally speaking, ownership of a substantial interest is considered to exist where the taxpayer and certain close relatives own an aggregate of at least 25 per cent of the corporate share capital. This type of legislation reflects the ability of shareholders owning substantial interests in closely held corporations to influence distribution policies to the shareholders' tax advantage. Other countries have approached this particular aspect by enacting legislation that seeks to prevent "unreasonable" accumulations of corporate income. In some countries this result is

sought by levying an almost confiscatory tax on the amount unreasonably retained in order to force distribution, and in others the amount unreasonably retained is imputed to the shareholders. Depending on the country, the reasonableness of the retention may be determined by formula, by the courts, or at the discretion of the taxing authorities.

Although the legislation of most countries contains provisions to prevent the tax-free extraction of undistributed corporate income by the more obvious methods, our interest was centred on those parts of the legislation that might prevent the more complex type of avoidance we have described as surplus-stripping. Because it would not be fruitful to examine anti-avoidance legislation in isolation from the legal and judicial system within which it operates, we concentrated on those countries with legal traditions somewhat similar to those in Canada.

The United Kingdom attempted at various times to prevent surplus-stripping by enacting legislation describing specific circumstances in which what otherwise would be a capital gain would be treated as income. This legislation had similarities with that in Canada, for it was directed at sales to security dealers and exempt persons among others. As in Canada, this detailed legislative approach proved to be unsuccessful. In 1960, legislation was introduced aimed at securities transactions specifically, but it was couched in reasonably general terms rather than spelled out in an attempt to cover all the specific situations in which it would apply. This legislation gave discretionary power to the Revenue to nullify any tax advantage obtained as a result of the transactions. It was apparently with considerable reluctance that Parliament accepted the view that such a provision was necessary to deal effectively with tax avoidance in this area. A number of safeguards were enacted including granting the taxpayer the right to obtain from the Revenue, within specified time limits, notification as to their view of the taxability of either proposed or completed transactions. Assessments made under this legislation were subject to appeal to the Special Commissioners and to a special tribunal set up for this purpose.

In Australia, the so-called "annihilating provision" 16/ has been contained in income tax legislation since 1915, but it was considered to have few teeth until the Commissioner won a resounding success in the Newton case 17/. After this case, a vigorous campaign utilizing this section was launched by the taxing authorities against arrangements that were considered to be substantially motivated by the opportunity of tax avoidance, and a number of lower court judgments favourable to the Crown resulted. However, it may be some time before it is finally determined how effective section 260 is as a means to halt surplus-stripping. As was stated in the judgment in the Newton case, if "...the transactions are capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then the arrangement does not come within the section".

In the United States, in contra-distinction to Canada and the United Kingdom, the anti-avoidance legislation has been buttressed by a sympathetic judicial response to the tax avoidance problem. A number of doctrines have emerged to supplement the intention of the legislature. These take into account such factors as the business purpose of a transaction, whether a distribution is substantially equivalent to a dividend, continuity of a proprietary interest, and compliance with the basic purposes rather than merely the form of the statute. In the United States, capital gains are taxable at special rates so that the amount of tax sought to be avoided is the difference between tax at progressive rates and a lower tax on capital gains, whereas in Canada it is the difference between tax at progressive rates and no tax.

Germany and South Africa have general anti-avoidance provisions not specifically directed at surplus-stripping. In Sweden, the intercorporate dividend exemption is denied to closely held corporations where the receiving corporation has failed to pay dividends to a reasonable degree; the denial is at the discretion of the National Tax Board.

CONCLUSIONS

Although it is not possible to determine the amounts of tax being avoided by surplus-stripping practices in Canada, this is not the prime consideration. Of considerable importance is the probability that the continued existence of widespread avoidance in this area will bring the entire tax system into such disrepute as to undermine the principles of self-assessment and voluntary compliance which form the foundation on which it operates.

Given the present flexibility of corporate organization and reorganization; given a tax system which permits the retention, within the corporate framework, of income potentially taxable on distribution; given the application of progressive personal tax rates to corporate distributions and the absence of tax on capital gains; given the traditional Canadian judicial approach to the interpretation of taxing statutes, it would probably be impossible to devise effective anti-avoidance legislation by particularizing in the statutes all types of transactions and their tax consequences. Such legislation would require the powers of a clairvoyant to foresee, let alone spell out, all possible combinations and permutations of circumstances and transactions which should result in the payment of tax. This type of approach, while reducing the extent of surplus-stripping, is likely to trap the innocent, to interfere with economically desirable corporate reorganizations and to provide to the sophisticated a catalogue of pitfalls that should be avoided. The only justification for detailed particularization and its associated complexity is that it provides some degree of certainty and denies to the tax administrators the power to make arbitrary assessments.

It seems clear that the anti-avoidance legislation enacted between 1949 and 1963, when section 138A was introduced, departed from the principle of personal progressive taxation of all income, and that it failed to pass the test of success that might have justified such a deviation.

Failing a basic change in the method of taxing income derived through the corporate form, some form of anti-avoidance legislation similar to that contained in the present section 138A(1) will be necessary, but it will have to be supplemented by procedures to provide speedy advance rulings to taxpayers contemplating transactions that might fall within its ambit. Such rulings should be binding on the Revenue provided full disclosure of all material facts was made by the taxpayer. It would also have to be supplemented by procedures to provide taxpayers with a speedy and final determination of tax liability where a transaction that might fall within the terms of the section had been consummated.

The only real answer to the problem of surplus-stripping is a basic change in the approach to the taxation of corporate source income. Only by eliminating the anomalies and inconsistencies inherent in the present system will it be possible to achieve freedom of action and flexibility in the carrying out of corporate transactions and reorganizations while not leaving room for widespread tax avoidance. The best way of accomplishing these ends would be to adopt the proposal for integration as recommended in Chapter 19, along with the taxation of capital gains at full rates as recommended in Chapter 15.

REFERENCES

1/ The gain made on a sale of shares is, generally speaking, a non-taxable "capital" gain.

2/ Occasionally, when the raison d'être of a widely held corporation has disappeared, it becomes public knowledge that it will be wound up and the directors indicate the date and amount of the liquidation distribution and how much of it represents undistributed corporate income. Because such an investment then becomes relatively more attractive to exempt organizations than to taxable shareholders, the market price should adjust to the point where it is mutually advantageous for many taxable shareholders to sell and for exempt organizations to buy.

3/ Because many of these schemes are unmanageable, and probably unnecessary, for widely held corporations, the practice is, as a general rule, confined to closely held corporations.

4/ House of Commons Debates, January 28, 1963, p. 3150.

5/ Income Tax Act, section 105B.

6/ Income Tax Act, section 85I.

7/ Income Tax Act, section 105C.

8/ This can happen because the vendors of the shares may have no control over what the purchasers do with the corporation.

9/ The following statement by the Minister of National Revenue was made on the matter:

> "For the proper exercise of discretion it is necessary for the minister to know all the circumstances surrounding the transaction or series of transactions, and this can only be known after the facts have been determined and each transaction has been completed. It will be recognized that the minister cannot exercise his discretion in advance or even find [sic] himself to exercise his discretion in a certain way in advance of the event. On the other hand, the

> officials of the taxation division are prepared, within limits, to discuss informally proposed transactions with taxpayers and their lawyers and accountants, but conclusions cannot be reached which will be binding on either the minister or the taxpayer."

House of Commons Debates, November 8, 1963, p. 4556.

10/ Because the normal corporation tax payable on a dividend paid out of "designated surplus" is usually prohibitive, and because the provisions of section 105A, which sets out the tax consequences of redeeming shares at a premium, were infrequently used, neither of these methods has been illustrated.

11/ For expansion of this comment see the section immediately following.

12/ The approach is indirect in that it levies a tax, at least potentially, on the purchaser of the shares in an attempt to reach the seller and presumed recipient of the benefit of the undistributed income.

13/ Based on tax under section 105B at 15 per cent, and ordinary non-resident withholding tax of 15 per cent on the balance.

14/ This assumes that all the dividend received would be taxed at the higher corporation tax rate of 50 per cent.

15/ In very general terms, the undistributed income accumulated since control of the corporation was acquired.

16/ Section 260 of the Income Tax and Social Services Contribution Assessment Act. This is a general anti-avoidance section not specifically directed at surplus-stripping.

17/ Newton and Others v. Commissioner of Taxation of the Commonwealth of Australia [1958] A.C. 450.

APPENDIX E

INCIDENCE OF TAXATION ON INDIVIDUAL SHAREHOLDERS UNDER THE PRESENT SYSTEM OF TAXING CORPORATE SOURCE INCOME

A common complaint about the present system of taxing corporate source income is that it results in the double taxation of corporate distributions. While the present dividend tax credit provides some relief, it is argued that the relief is inadequate and has inequitable application among shareholders.

Double taxation is nearly always criticized as being unjust and discriminatory, with the implication that it is to the shareholder's disadvantage in all circumstances. If it is accepted that the income of a corporation is the income of its individual shareholders whether or not distributed to them, then the portion distributed will form the base for two levies of tax, one levy on the corporation by means of corporation income tax and another levy on shareholders when they receive dividends. The existence of these two levies appears to be responsible for the objections concerning double taxation. However, an examination of the effects of these taxes is necessary before it can be conceded that double taxation is quite as opprobrious as is sometimes asserted. To determine the effects, calculations were made of double taxation under a variety of corporate and shareholder circumstances on the assumptions that it is the same income that is being taxed twice, 1/ and that shareholders bear all the corporation income tax. The problem of the incidence of the corporation income tax is discussed at length in the *Report*, but for this particular purpose it is assumed that it is borne by the shareholders.

It is evident that the term "double taxation" is not at all precise in describing the actual tax situation. For example, it does not adequately describe the extreme inequity that arises where corporate income is subjected to a 50 per cent corporation income tax and the shareholder is a low income individual not liable for tax. More precise and less emotional terms

suggested by an authority in assessing this problem are "relative undertaxation" and "relative overtaxation" 2/. If the total of corporation and personal income taxes levied on a given amount of distributed corporate income exceeds the personal tax that would have been levied on an equivalent amount of income received directly by the shareholder, relative overtaxation is said to result, and where it is less, relative undertaxation results. These terms will be used to better explain the results of double taxation in various circumstances.

In the case of closely held corporations whose shareholders are actively employed in the business (these corporations might be considered as incorporated proprietorships or partnerships), there need never be relative overtaxation, and above a certain income level, there can always be relative undertaxation by withdrawing the corporate income by the optimum mix of salaries, dividends and elections under section 105 of the Income Tax Act. This is illustrated in Table E-1 in the case of an incorporated proprietorship. This table assumes full distribution and therefore no further liability for tax exists. In the event that full distribution does not take place, further saving in the amount of tax immediately payable can be achieved. This saving is only a postponement of the tax, but postponement of payment in itself has a value, particularly where the postponement is to the remote future.

Shareholders of a closely held corporation who are not employed by the corporation do not have the same flexibility in withdrawing corporate income as do the employee-shareholders described in the preceding paragraph but, where their tax circumstances are somewhat similar, advantage can be taken of the election available under section 105. In these circumstances they may withdraw the corporate income either as a dividend or as a combination of dividend and section 105 election in the optimum amounts. It should also be noted that, to some extent at least, the payment of directors' fees in reasonable amounts can bring their situation closer to that of the shareholder who is a full-time employee.

TABLE E-1

COMPARISON OF TAXES PAYABLE BY AN UNINCORPORATED PROPRIETORSHIP OR SALARIED EMPLOYEE AND BY AN INCORPORATED PROPRIETORSHIP USING DIFFERENT METHODS OF DISTRIBUTION

Income	Tax Payable by an Unincorporated Proprietor or Salaried Employee	Tax Payable By Incorporated Proprietorship: If Corporate Income is Withdrawn By a Combination of Salary and Dividends	Tax Payable By Incorporated Proprietorship: If Corporate Income is Withdrawn By a Combination of Salary, Dividends and an Election Under Section 105	Amount and Percentage of Relative Undertaxation Under (3)		Amount and Percentage of Relative Undertaxation Under (4)	
(dollars) (1)	(dollars) (2)	(dollars) (3)	(dollars) (4)	(dollars) (5)	As a percentage of column (2) (6)	(dollars) (7)	As a percentage of column (2) (8)
7,100	1,140	1,140	1,140	-	-	-	-
8,000	1,374	1,371	1,371	3	.22	3	.22
10,000	1,930	1,891	1,891	39	2.02	39	2.02
15,000	3,720	3,394	3,394	326	8.76	326	8.76
20,000	5,915	5,114	5,114	801	13.54	801	13.54
25,000	8,165	7,103	6,840	1,062	13.01	1,325	16.23
35,000	13,110	11,255	10,235	1,855	14.15	2,875	21.93
40,000	15,610	13,755	12,045	1,855	11.88	3,565	22.84
60,000	26,555	24,333	22,681	2,222	8.37	3,874	14.59
100,000	50,945	47,987	44,454	2,958	5.81	6,491	12.74
200,000	119,640	116,315	109,249	3,325	2.78	10,391	8.69
300,000	193,335	189,702	174,684	3,633	1.88	18,651	9.65
400,000	268,335	264,643	240,119	3,692	1.38	28,216	10.52
500,000	348,280	344,220	305,554	4,060	1.17	42,726	12.27

Note: An incorporated proprietorship is a closely held corporation whose shareholders are actively employed in the business. In this table it is assumed that the incorporated proprietorship has only one shareholder, that the optimum mix of salary, dividends and section 105 elections has been utilized, that full distribution has taken place and that the taxpayer-shareholder is entitled to a standard deduction of $1,100. The tax rates used were those in effect in 1963.

Because the circumstances of individual shareholders of closely held corporations may vary so greatly, it is not always possible to illustrate the situation as simply as was done in Table E-1, where it is assumed that the shareholder's main source of income was the corporation. Table E-2 shows the incidence of combined corporation and personal income taxes in the case of shareholders of a closely held corporation who are not employees. It is assumed that the shareholders have other income and accordingly the personal tax is calculated at the marginal rate indicated. It is also assumed that the income is distributed by the best possible mix of dividends and elections under section 105. Table E-3 shows the incidence of corporation and personal taxes in the case of a publicly traded corporation. It differs from Table E-2 in that it assumes that the 50 per cent corporate rate is applicable to all of the income, and that all distributions (either all or one half of the income after tax) are by way of cash dividends. The tables show for each personal income bracket the degree of relative overtaxation or undertaxation as compared with taxation of all the income at the personal rate.

It will be seen from Table E-2 that relative overtaxation is suffered at the lower income end of the scale whether the corporation is subject to tax at 21 per cent or 50 per cent, and that the degree of relative over-taxation gradually diminishes as the shareholder's other income increases until a point is reached when the high income shareholder is subject to relative undertaxation. It is obvious that the degree of relative over-taxation at the 50 per cent corporate rate will be much greater than at the 21 per cent corporate rate, and that the personal income level at which relative overtaxation changes to relative undertaxation in the case of the 21 per cent rate will be much below that at which it occurs in the case of the 50 per cent rate.

Table E-2 has been prepared on the basis that the entire corporate income is distributed and that no further tax is exigible thereon. This is, of course, an unrealistic assumption because full distribution is a rarity. To the extent that distribution does not take place some tax is postponed,

TABLE E-2

COMPARISON OF TAX PAYABLE ON $100 OF ADDITIONAL INCOME FROM A CLOSELY HELD CORPORATION

Personal Income Bracket	Tax Payable By Unincorporated Proprietor or Salaried Employee a/	If Received Through a Corporation Taxable at 21 per cent: Combined Corporation And Individual Income Tax Payable	If Received Through a Corporation Taxable at 21 per cent: Relative Overtaxation or (Undertaxation) as Compared With (2)		If Received Through a Corporation Taxable at 50 per cent: Combined Corporation And Individual Income Tax Payable	If Received Through a Corporation Taxable at 50 per cent: Relative Overtaxation or (Undertaxation) as Compared With (2)	
(dollars) (1)	(dollars) (2)	(dollars) (3)	(dollars) (4)	As a percentage of column (2) (5)	(dollars) (6)	(dollars) (7)	As a percentage of column (2) (8)
No taxable income	-	21.00	21.00	-	50.00	50.00	-
1 - 1,000	14.00	16.26	2.26	16.14	47.00	33.00	235.71
1,000 - 2,000	17.00	18.63	1.63	9.59	48.50	31.50	185.29
2,000 - 3,000	20.00	21.00	1.00	5.00	50.00	30.00	150.00
3,000 - 4,000	19.00	20.21 b/	1.21	6.37	49.50 b/	30.50	160.53
4,000 - 6,000	22.00	22.58	.58	2.64	51.00	29.00	131.82
6,000 - 8,000	26.00	25.74	(.26)	(1.00)	53.00	27.00	103.85
8,000 - 10,000	30.00	28.90	(1.10)	(3.67)	55.00	25.00	83.33
10,000 - 12,000	35.00	32.85	(2.15)	(6.14)	57.50	22.50	64.29
12,000 - 15,000	40.00	34.83 c/	(5.17)	(12.92)	58.75 c/	18.75	46.88
15,000 - 25,000	45.00	36.81	(8.19)	(18.20)	60.00	15.00	33.33
25,000 - 40,000	50.00	38.78	(11.22)	(22.44)	61.25	11.25	22.50
40,000 - 60,000	55.00	40.76	(14.24)	(25.89)	62.50	7.50	13.64
60,000 - 90,000	60.00	42.73	(17.27)	(28.78)	63.75	3.75	6.25
90,000 -125,000	65.00	44.71	(20.29)	(31.22)	65.00	-	-
125,000 -225,000	70.00	46.63	(23.32)	(33.31)	66.25	(3.75)	(5.36)
225,000 -400,000	75.00	48.66	(26.34)	(35.12)	67.50	(7.50)	(10.00)
400,000 and over	80.00	50.63	(29.37)	(36.71)	68.75	(11.25)	(14.06)

a/ Tax rate schedule for 1963.

b/ It has been assumed that to this level it has been possible to utilize the dividend tax credit against tax on other income.

c/ At this point it is assumed that the corporation after-tax income has been distributed one half by cash dividend and one half by election under section 105.

TABLE E-3

COMPARISON OF TAX PAYABLE ON $100 OF ADDITIONAL INCOME FROM A WIDELY HELD CORPORATION

		Tax Payable if Received Through a Corporation Taxed at the 50 per cent Corporate Rate					
		Where All Corporate After-Tax Income is Distributed			Where Only One Half of Corporate After-Tax Income is Distributed		
Personal Income Bracket	Tax Payable By Unincorporated Proprietor or Salaried Employee a/	Combined Corporation And Personal Income Tax	Relative Overtaxation or (Undertaxation)		Combined Corporation And Personal Income Tax	Relative Overtaxation or (Undertaxation)	
(dollars) (1)	(dollars) (2)	(dollars) (3)	(dollars) (4)	As a percentage of column (2) (5)	(dollars) (6)	(dollars) (7)	As a percentage of column (2) (8)
No taxable income	-	50.00	50.00	-	50.00	50.00	-
1 - 1,000 b/	14.00	51.50	37.50	268.0	50.75	36.75	262.5
1,000 - 2,000 b/	17.00	51.50	34.50	203.0	50.75	33.75	198.5
2,000 - 3,000 b/	20.00	51.50	31.50	157.5	50.75	30.75	153.7
3,000 - 4,000 b/	19.00	50.00	31.00	163.2	50.00	31.00	163.2
4,000 - 6,000	22.00	51.00	29.00	131.8	50.50	28.50	129.6
6,000 - 8,000	26.00	53.00	27.00	103.9	51.50	25.50	98.1
8,000 - 10,000	30.00	55.00	25.00	83.3	52.50	22.50	75.0
10,000 - 12,000	35.00	57.50	22.50	64.3	53.75	18.75	53.6
12,000 - 15,000	40.00	60.00	20.00	50.0	55.00	15.00	37.5
15,000 - 25,000	45.00	62.50	17.50	38.9	56.25	11.25	25.0
25,000 - 40,000	50.00	65.00	15.00	30.0	57.50	7.50	15.0
40,000 - 60,000	55.00	67.50	12.50	22.7	58.75	3.75	6.8
60,000 - 90,000	60.00	70.00	10.00	16.7	60.00	-	-
90,000 - 125,000	65.00	72.50	7.50	11.5	61.25	(3.75)	(5.8)
125,000 - 225,000	70.00	75.00	5.00	7.1	62.50	(7.50)	(10.7)
225,000 - 400,000	75.00	77.50	2.50	3.3	63.75	(11.25)	(15.0)
400,000 and over	80.00	80.00	-	-	65.00	(15.00)	(18.7)

a/ Tax rate schedule for 1963.

b/ It has been assumed that the taxpayer is unable to use the full dividend tax credit against tax on other income.

and, if the shares can be sold at a price which reflects all or part of these retained earnings, this postponed tax liability will not have to be met by the vendor. Although one of the characteristics of this type of corporation is that there is not normally a ready market for the shares, particularly where they represent a minority interest, nevertheless the postponed tax liability is often avoided by surplus-stripping.

Table E-3 illustrates the extent of relative overtaxation or undertaxation in respect of income from widely held corporations. The shareholder may well be described as the portfolio-type investor. He has little or no influence in the affairs of the corporation, and the corporation's shares are readily marketable either because they are listed on a recognized stock exchange or are actively traded over the counter. Because the individual shareholder has little influence in the affairs of the corporation and because of the diversity of tax circumstances of the many shareholders, it is unlikely that the shareholder will be able to obtain the benefit of the corporation's earnings except by way of dividend or, to the extent that retained earnings are reflected in share prices, by sale of the shares.

Table E-3 shows that the greatest relative overtaxation takes place where the shareholder has no taxable income and only one tax is levied. The amount of relative overtaxation diminishes as the income rises. Where all corporate after-tax income is distributed as a dividend, relative undertaxation is never reached. Where only one half of corporate after-tax income is distributed as a dividend, relative undertaxation results when the individual is at or over the $90,000 personal income bracket, and it becomes greater as the personal income bracket becomes higher.

The validity of the complaints about overtaxation must be judged, therefore, from the various findings above. In summary, it can be said that the so-called double taxation works to the advantage of some taxpayers and to the disadvantage of others, depending on a number of circumstances. Generally, the disadvantage falls most heavily on the low income shareholders of large income corporations.

REFERENCES

1/ This approach is in keeping with the comprehensive concept of income used in the Report which does not call for the taxation of organizations other than as a means of reaching the individuals who own the organization.

2/ Richard Goode, The Postwar Corporation Tax Structure, New York: New York Tax Institute Inc., 1947.

APPENDIX F

ALTERNATIVE METHODS OF TAXING CORPORATE SOURCE INCOME

The present Canadian method of taxing corporate source income is not satisfactory. In this appendix a number of alternative methods of taxing income derived through the corporate form are considered from the point of view that the best solution would be one that resulted in corporate source income bearing the same burden of tax as income derived through any other method of doing business. Neutrality of tax treatment, however impossible of complete attainment, should be the objective.

The broad concept of income adopted in the Report recognizes income as being attributable to individuals only, and not to artificial entities or organizations. The annual income (or loss) that an individual derived from ownership of an interest in a corporation would be measured, ideally, as the sum of the dividends and other distributions received during the year and the annual change in market value of his shares in the corporation. His total income (or loss) over time would be the sum of the dividends received throughout his period of ownership and the difference between his original cost and the amount ultimately realized on the final sale of his share. The current income of a corporation would only be one of the determinants, albeit an important one, of the income of a shareholder-individual under this broad concept 1/. If the annual income of the shareholder-individual was measured on this ideal basis, and if all shareholders were resident in Canada, there would be no necessity to levy income tax either on the corporation or at the corporate level.

To apply this concept completely, however, would require an annual valuation of all shares. In the case of actively traded shares, this would be relatively easy, but in the case of closely held family corporations no active market exists and the valuation of shares of such corporations would be a contentious, time-consuming process producing such approximate results as to render annual measurement of income on this basis impractical.

Once it is conceded that income from holding corporate shares cannot be taxed on a complete annual accrual basis, it becomes necessary to prevent the undue postponement of tax liability which would result if individuals were taxed on dividends received and therefore caused income to accumulate in the hands of corporations.

The ensuing sections of this appendix will examine various methods by which corporate source income can best be related to the various shareholders in such a way as to prevent postponement of tax, and to ensure that each shareholder's income derived from the ownership of corporate shares is charged with its appropriate burden of taxation as far as possible.

From our review of the existing Canadian system of taxing corporate source income, it is evident that if a deferment of distribution resulted in a delay in the application of any material additional tax levy, corporate profits would tend to be retained within the corporate vehicle whether they were required for the particular business or not.

One method of preventing postponement of tax would be the application of incentives or inducements to encourage distribution and, consequently, the integration of corporation and personal income and taxes. However, it is apparent that whatever would induce actual distributions by a corporation, whether it be a special tax on retained earnings or a lower rate of tax on distributed earnings, would likely be regarded as a penalty on retentions and would result in an undesirable tax bias toward distributions. For these reasons, such a solution would be inferior to one that was not dependent on actual distributions, that provided an incentive toward integration of the personal and corporation tax structures, and that was relatively neutral at the corporate level as between distribution and retention.

The Full Attribution or Partnership Method

Under this method, the corporate source income, whether or not distributed, would be attributed annually to the various shareholders. Shareholder-

individuals would include in income their attributed portion of the corporate source income, and would pay tax thereon at their appropriate personal progressive rates. Shareholder-corporations would also include in income their attributed portions of such income so that they would in turn be further attributed until ultimately attributed to individual shareholders. Dividends would not be relevant in computing annual income. To this point the method is somewhat similar to that currently accorded to the income of a partnership or of a personal corporation. However, to conform to the comprehensive tax base adopted in the Report, a final adjustment would be required on ultimate realization, or deemed realization, of the corporate shares. To determine this final adjustment, it would be necessary for each shareholder, both corporate and individual, to maintain records showing the cost of acquisition of the particular corporate shares, to which would be added the amounts of corporate source income attributed, 2/ and from which would be deducted the dividends received in respect of those shares. The difference between this adjusted cost and the proceeds or deemed proceeds of realization would represent the amount of the final adjustment.

At first sight, this method appears to be an ideal solution. It would result in corporate source income being taxed at the same rates as other forms of income, there would be no difference in treatment between distributed and undistributed income, a tax at the corporate level would be unnecessary, and the deviations from the comprehensive tax base that were occasioned by the annual use of corporate source income as a measure of the increase in value of corporate shares would be adjusted on realization.

Such a method is feasible for certain corporations which have small numbers of shareholders and simple capital structures and resemble incorporated partnerships, and for these corporations we have recommended an option to be taxed as a partnership. However, it presents administrative and compliance problems of alarming proportions when considered in relation to corporations with complex capital structures and large numbers of shareholders.

Apart from the complexities arising in connection with non-resident shareholders, such problems include the necessity of allocating the corporate source income to myriads of shareholders. Some shares may be registered in the names of nominees such as banks and brokers, and the same nominee may hold shares for many different taxpayers. The conflicting interests of different classes of shareholders could create either serious re-allocation problems or inequities. Unless the corporation consistently made profits sufficient to cover the contractual dividend entitlement of all classes of shares other than the most junior, it might be necessary to pay dividends to preferred shareholders out of funds taxed in the hands of common shareholders. The alternative of re-allocating prior years' corporate source income on some equitable basis, particularly where shareholdings are subject to rapid turn-over, presents insuperable difficulties. Intercorporate shareholdings introduce additional complexities in the determination of corporate source income and could make timely allocation and information to shareholders impossible 3/. No useful purpose would be served by cataloguing other problems associated with this method. But even if the administrative problems could be solved, it may be questioned whether public acceptance could be achieved for a method that could require a shareholder in a widely held corporation to make a cash payment for tax on corporate source income from which he had received no distribution.

It is not necessary to consider in any detail the additional problems that would be associated with non-resident share ownership but these would include problems of collection and of determining the rates of tax appropriate to particular non-residents.

Therefore, despite its theoretical attractions, it is apparent that the full attribution or partnership method is not practicable.

No Tax at the Corporate Level

The only other general approach that does not involve the imposition of a tax at the corporate level would require that dividends and gains or losses

on realization of shares be included in the income of shareholders. In computing income, the individuals would include dividends received and realized gains or losses and would pay tax thereon at progressive personal rates. No tax would be exigible in respect of either dividends received or gains on shares realized by corporations until they were distributed by way of dividend to individuals, or until an individual realized on his shares in the corporate shareholder.

Although such an approach would eliminate many of the difficulties associated with the full attribution method, it would permit postponement of the recognition of income for tax purposes at the option of the taxpayer. Apart from the obvious inequity that the option would not be available to all taxpayers, the effect on government revenues would be serious. On average, corporate surpluses increased by approximately $1,250 million per annum from 1952-61. The additional incentive of being able to retain income free of tax within the corporate structure would undoubtedly cause this figure to increase, and theoretically all tax in respect of undistributed corporate source income could be postponed during the lives of resident shareholders. Of even greater concern would be the probability that unless some method could be devised for collecting tax from non-resident shareholders in respect of gains on realization of shares, the undistributed corporate source income attributable to their period of ownership would escape Canadian taxation entirely. For Canada, with such a large degree of non-resident ownership of corporations, the loss of revenue would be considerable.

Consequences of a Tax at the Corporate Level

The above alternatives do not involve the imposition or collection of a tax at the corporate level. With their rejection, the collection of some form of tax at the corporate level becomes unavoidable. At a minimum, this tax must prevent the tax-free accumulation of corporate income. Whether it

is levied in respect of the undistributed portion of corporate source income only or in respect of both distributed and undistributed corporate source income, it is implicit in the concept of the comprehensive tax base that the tax be imposed at the corporate level only as a means of reaching the individual to whom the benefit of the corporate source income ultimately accrues. Thus, the levy of a tax at the corporate level requires that, in equity, this tax should also be related to the relevant shareholders and that credit should be given for it to the extent possible.

Quite apart from the structural problems associated with relating corporate source income to individuals and integrating a tax at the corporate level with personal income tax, a corporation income tax raises the problem of the double taxation of corporate source income. As Appendix E to this Volume demonstrates, the question is not simply one of double taxation. Furthermore, the economy has adjusted to the presence of an unintegrated or, at best, partially integrated corporation tax. However, the integration of the corporation tax with the personal tax rate structure would be desirable because this action would eliminate the distortions in the allocation of resources caused by an unintegrated corporation tax.

This decision calls for an examination of various methods whereby, not only would corporate source income be attributed to the various shareholders, but the tax levied at the corporate level would also be integrated with personal income taxes. The various alternatives are outlined below.

Deductibility of Dividends

Although a tax levy at the corporate level is essential in respect of undistributed corporate source income, it may be questioned whether it is necessary in respect of distributions from a current year's income. If dividends paid were made deductible in computing the tax to be levied at

the corporate level and recipients of the dividends were required to include those amounts in income, taxation at personal progressive rates would be achieved for the distributed portion of the corporate source income and the problems of integration in respect of that portion would be solved.

In principle, a strong case can be made for this proposal. It would tax currently distributed corporate source income in the same manner as other types of income, and, by placing loan interest and dividend payments on a similar footing would apparently remove or at least reduce any bias that may exist in favour of financing corporate expansion by debt rather than equities.

However, the proposal has a number of disadvantages quite apart from the revenue implications that arise from the high degree of non-resident ownership of Canadian corporations. The use of a year as the period for measurement of income would produce imperfect results if losses were to be carried back and forward over a reasonable period. The same rationale would require that a similar type of provision should be made for carrying back or carrying forward dividends paid in excess of corporate source income to those years where this income exceeded dividends paid. This would create certain administrative difficulties and could result in the wrong shareholder receiving benefits, but the difficulties should not in themselves prove insuperable. The proposal could have more serious consequences, however, because it could easily come to be regarded as a form of penalty tax on retained earnings, particularly if on a subsequent distribution the tax on retained earnings was not fully integrated with the personal income tax 4/. Such a belief would result in pressure for increased distributions. The proposal would also be open to criticism on the ground that it would bear more heavily on expanding corporations whose financial needs were greater than those of more mature corporations, although this latter objection could be partially overcome if stock dividends were treated as distributions for tax purposes 5/.

However, the most convincing argument against acceptance of this proposal

as suitable for Canada results from the high degree of non-resident ownership of Canadian corporations. Deductibility of dividends would, in the absence of other compensating legislation, result in the collection of only a withholding tax in respect of dividends distributed to non-residents. Any attempt to increase non-resident withholding taxes to recoup the loss of tax revenue associated with non-resident ownership of corporate shares would have widespread repercussions. That this could be so, even though the increased non-resident withholding tax did not exceed the total of the present corporation tax plus the non-resident withholding tax in respect of distributed corporate income, is evidenced by the following statement:

> "In several recent negotiations the United States has been presented with the need to consider the relationship of the standard treaty withholding provision on dividend income to a variety of domestic tax policies of the other treaty countries. These tax policies have caused the other contracting parties to seek a treaty withholding rate on dividends going to the United States which would be higher than the United States rate on dividends going to the foreign country. For example, in Germany the tax policy involved is that of a split rate corporation tax under which distributed profits are taxed at a substantially lower rate than undistributed profits. Such an internal policy is said to require a higher withholding rate on dividends paid by a German subsidiary to its foreign parent than is customary under standard treaties and the OECD Draft—which is 5% in certain parent-subsidiary cases and 15% on other dividends. In other situations, as in Belgium, the problem may arise from an opposite approach to the internal double taxation of dividends, under which the domestic shareholder receives a tax credit for a part of the corporate tax, and from the internal development of that policy. In other cases, as in Canada, the problem may arise from a desire to differentiate between domestic subsidiaries with a high degree of foreign ownership and those with greater domestic participation.
>
> "Whatever the cause of the issue, the United States has found itself in the position of being asked to agree to a treaty provision under which our withholding rate on dividends to a particular country would be less than the rate levied by that country on dividends moving to the United States. We have in these cases—in order to protect our investors from an increased level of foreign taxation and to protect the United States from revenue loss under the foreign tax credit—taken the firm position that international withholding rates should be reciprocal and hence we cannot agree to an upward adjustment by other countries to accommodate to their internal tax policies. In the simplest case, for example, the fact that a foreign country may have a corporate tax rate of 30% compared to the U.S. 48% rate does not warrant a non-reciprocal set of withholding rates under which the rate of the foreign country would be higher than ours. Moreover, we do not prefer a solution which makes the rates reciprocal through an

> increase in our rate as well, since that course is both contrary to the OECD Draft and to the policy behind that Draft of relieving double taxation and granting more freedom to international capital movements." 6/

As an indication of the revenue loss that might be sustained in the non-resident sector if dividends were made deductible and a compensating increase in non-resident withholding tax was not imposed, dividends paid to non-residents in the years 1959-63 averaged in excess of $540 million 7/. On a reasonable assumption that these dividends were paid out of profits that had first been subjected to corporation tax at an average rate of 40 per cent, they represent before-tax corporate income of some $900 million on which $360 million of corporation tax was paid. Given that the present retention policies of Canadian corporations are adequate, it is likely that if dividends were made deductible, dividend payments would be increased to at least $900 million with a consequent loss of some $300 million in annual tax revenue 8/. Where the domestic tax situation of non-resident shareholders was such that tax advantages could be obtained from increased dividend payments by Canadian corporations, it is likely that dividend payments by foreign-controlled Canadian corporations would increase, resulting in a higher revenue loss. Such funds, withdrawn by way of dividend, as were required for adequate financing of the Canadian subsidiary corporation could be returned to Canada by way of loan or new equity capital but, in general, there would be a tendency for these increased dividends to remain abroad. It is impossible to estimate what the effect of this would be on Canada's balance-of-payments position.

Therefore, despite its apparent attractions, the deductibility of dividends in computing corporate income is a method that would be quite unsuitable for Canada.

This conclusion makes an income tax at the corporate level inevitable. The remainder of this appendix reviews methods whereby this tax at the corporate level in respect of distributed corporate earnings may be integrated

with the personal tax rate structure by means of various forms of dividends-received credit.

Forms of Dividends-Received Credit

Gross-Up and Credit at the Prevailing Corporate Rate for the Year on All Distributions Whether Out of Taxed or Untaxed Income. Essentially this method calls for a flat rate of tax on income at the corporate level, which tax would be deemed to have been paid on account of shareholders, but no attempt would be made to relate either the income or the tax to shareholders until distribution took place. When a distribution took place or was deemed to take place, as in the case of a stock dividend, it would be assumed to have been paid from income that had borne tax at the prevailing corporate rate, whether or not it had done so, and the resident taxable shareholder would be required to include in income the gross equivalent of the actual distribution received. He would also be given credit for the tax assumed to have been paid on his behalf 9/. On final computation of the shareholder's personal tax liability for the year in question an appropriate adjustment would be made. Where the tax assumed to have been paid on the shareholder's account proved to be above his personal rate, a refund would be made; if it proved to be below his personal rate the shareholder would make up the deficiency 10/. Although this method is not identical with the system recently discontinued in the United Kingdom, 11/ there is sufficient similarity that their experience and the criticisms levelled at their system are useful.

Given ideal conditions, this proposal would almost completely integrate the corporation and personal income tax rate structures and would result in the distributed portion of corporate source income bearing tax at appropriate personal progressive rates. However, such ideal conditions could only be attained where the corporate rate of tax did not fluctuate significantly and under which all sources of corporate surplus were subject to taxation at the full corporate rate. Even under

ideal conditions, personal progressive rates would only apply to distributed corporate source income, particularly if the corporate rate was lower than the top personal rate. The progressive rates applied would not necessarily be those of the shareholders who owned the shares when the income was earned, although the full taxation of share gains and losses would remove most of the possibilities of tax avoidance.

Examined in the light of current conditions and practices and the accepted use of taxation as an economic tool, this method would be attractive only if accompanied by a number of other specific provisions to prevent its misuse and overcome its defects. The principal requirement would be that any corporate income which was not taxed at the full rate when earned be subject to an additional tax at the time it was distributed. This is the approach recommended in the Report, in conjunction with the inclusion in the computation of income of capital gains and losses. It is dealt with at length in Chapter 19 and Appendix H to this Volume.

The introduction of a system of gross-up and credit irrespective of the effective rate of corporation tax borne by the income from which the dividend was paid could produce some anomalies. In the absence of restricting legislation, credits would be given and refunds made in respect of dividends derived from foreign source income that had borne little or no Canadian tax and that might indeed have borne no tax, Canadian or foreign. It would be possible to enact legislation to deny refunds except to the extent that Canadian tax had been paid on foreign source income, 12/ but this would introduce further complexity. Controversy could arise where, as a result of incentive legislation, no tax had been paid at the corporate level but credits were given and refunds made in respect of dividends paid out of that untaxed income. This very situation was the cause of public criticism in the United Kingdom where there was no limitation on the credit for dividends paid out of foreign source income.

The remission of corporation tax on income can sometimes be justified as an economic incentive to influence business activity in a desired direction, but whether the remission of tax should be extended to the shareholders when the income is distributed depends on the purpose of the incentive and whether that purpose can be achieved only by retention of funds within the corporate structure. A gross-up and credit at the prevailing corporate rate where no tax had been paid assumes the nature of a subsidy to shareholders, a result that might well be the intention of some incentives.

The Dividend Tax Credit. Under the method now prescribed in the *Income Tax Act* of giving credit for corporation income tax, the shareholder includes in his income the actual dividend received and deducts from his liability for income tax a flat percentage of the dividends received from a taxable Canadian corporation. There is no provision for refund where the amount of the dividend tax credit exceeds the income tax otherwise payable.

Ignoring the actual rates in effect in Canada 13/ and assuming a single flat rate of corporation tax of 50 per cent which is regarded as having been paid on behalf of its shareholders, the effect of a 50 per cent dividend tax credit is illustrated in Table F-1 for taxpayers with varying marginal rates of tax.

It will be observed that progressiveness in relation to the personal rate structure is greatly reduced and the integration effect is only partial.

As a means of integrating corporation and personal income taxes, the Canadian method of dividend tax credit, despite the attractions of its simplicity, is inferior to the "gross-up and credit at the prevailing rate" referred to above. It is also subject to many of the criticisms to which that method is subject in the absence of specific provisions to prevent its misuse.

TABLE F-1

ILLUSTRATION OF THE EFFECT OF A DIVIDEND TAX CREDIT

	Individual Marginal Rate 10 per cent	20 per cent	30 per cent	40 per cent	50 per cent
Actual dividend received (assumed to derive from $100 of corporate source income less 50 per cent tax)	$50.00	$50.00	$50.00	$50.00	$50.00
Personal tax thereon at the marginal rate	5.00	10.00	15.00	20.00	25.00
Add: Tax levied at the corporate level	50.00	50.00	50.00	50.00	50.00
	55.00	60.00	65.00	70.00	75.00
Deduct: Dividend tax credit a/ of 50 per cent of dividend received	25.00	25.00	25.00	25.00	25.00
Net tax payable	$30.00	$35.00	$40.00	$45.00	$50.00

Note:

a/ For our purposes, it has been assumed that refunds are permissible to the extent that the dividend tax credit exceeds the tax otherwise payable in respect of the dividend. To prohibit refunds would result in no tax at the personal level and a flat 50 per cent at the corporate level, thereby eliminating all progressiveness.

Partial Exclusion of Dividends Received From Shareholder's Income. This method gives a measure of tax relief to the individual shareholder by excluding from his income either a percentage of the dividends received from Canadian corporations or, alternatively, all dividends received from Canadian corporations up to a maximum amount. It is evident, even on a cursory examination, that this proposal is inferior to a dividend tax credit.

REFERENCES

1/ This total income would represent, among other things, changes in the market assessment of the goodwill of the corporation and, possibly, an adjustment for the difference between the undepreciated capital cost of fixed assets and their estimated value.

2/ "Corporate losses" attributed would be deducted.

3/ Circular intercorporate shareholdings would require the use of mathematical formulae.

4/ Because this problem is also common to alternatives to be discussed later, it will not be developed further at this point.

5/ Under the present Income Tax Act stock dividends are so treated only to the extent of undistributed income on hand.

6/ S. S. Surrey, "The United States Tax System and International Tax Relationships", Canadian Tax Journal, Vol. XII, 1964, p. 460 at p. 463. Mr. Surrey is Assistant Secretary of the United States Treasury.

7/ Derived from Table I, National Accounts, Income and Expenditure 1963, Dominion Bureau of Statistics, Ottawa: Queen's Printer, 1964.

8/ A loss of $360 million in corporation tax minus a gain of approximately $54 million in non-resident withholding tax.

9/ Given that the average rate of corporation tax is presently about 45 per cent, the recipient of a dividend of $55 would be required to include $100 in income and would take credit for $45 deemed to have been paid by the corporation on his account.

10/ Where the shareholder was another tax-paying Canadian corporation, no additional tax would be exigible but refunds might result. This could occur where either the receiving corporation sustained a trading loss

or where it had tax-exempt status and no legislation existed denying refunds of tax in such circumstances.

11/ The reference here is to the standard rate of income tax and does not take into consideration the corporation profits tax. This latter tax was an unintegrated corporation tax. See Appendix G to this Volume.

12/ In the United Kingdom refunds were limited in this manner.

13/ The existence of a dual rate of corporation tax limits the percentage of credit for dividends included in income to the lower of the two rates thereby severely limiting its potential as a means of integration.

APPENDIX G

THE FOREIGN TAXATION OF CORPORATE PROFITS

The taxation of corporate profits by various economically advanced countries reveals no consistency of treatment, either of corporations or their shareholders. In some instances, the provisions of the law find their roots in history and have not kept pace with changes in the theoretical conception of the corporation or in other provisions of the tax law. In other cases, the rules for the taxation of corporations are instruments of economic policy and are moulded to advance that policy so that they take their character from the national setting in which they are to function.

In this appendix an examination is made of the provisions for the treatment of corporate profits of the United Kingdom, France, West Germany and the United States. This is a somewhat arbitrary selection, but it is representative of different schools of thought. The laws of the United Kingdom and France are of current interest because of major changes in their methods of taxing corporate source income that have recently been enacted.

United Kingdom

Tax Treatment of Corporate Profits and Dividends Prior to 1965. Prior to the fundamental reforms in the tax treatment of corporate profits enacted in the Finance Act, 1965, the essential features of the British system of taxing corporations and their shareholders may be stated as follows.

Corporations were subject to a profits tax which was imposed at a rate of 18 per cent on profits in excess of £2,000 and up to £12,000, and at the rate of 15 per cent on profits in excess of £12,000. The taxable profits included investment income, except for "franked investment income", that is, dividends received directly or indirectly out of corporate profits which were themselves subject to profits tax. The effect was that dividends received from resident corporations were not ordinarily subject to profits tax.

In 1947, as a result of the financial and economic conditions then prevailing, provision was made for the imposition of profits tax at differential rates; distributed profits attracted tax at a rate significantly higher than the rate applicable to undistributed profits. The United Kingdom Royal Commission on the Taxation of Profits and Income was highly critical of this innovation on the grounds that it caused inequity to certain shareholders, complexity in the legislation, and largely failed to accomplish the main economic purposes which it was intended to serve, namely, to restrain inflation and encourage productive investment in the form of ploughed-back profits 1/. The Commission recommended that the differential rates be brought to an end and that the tax be converted into a flat-rate tax on total profits. These recommendations were adopted in 1958. 2/

Corporations were also chargeable to income tax at the standard rate, that is, the flat rate which is fixed annually in the Finance Act, in the same way as individuals, but without benefit of any of the personal reliefs and allowances. They were not, however, liable to surtax, which is an additional tax charged at graduated rates in respect of the income of individuals in excess of a specified amount, except in the case of certain closely controlled corporations which were utilized to accumulate income so as to avoid surtax on their shareholders.

When a corporation paid a dividend to shareholders, it was entitled, but not obliged, to deduct and retain a sum equivalent to tax at the standard rate in force for the year in which the dividend was due. Whether tax was withheld or not, the dividend was not chargeable with standard tax in the hands of the shareholder, because it was derived from a fund that ordinarily had borne income tax in the corporation's hands. However, for personal allowance and surtax purposes, the shareholder's total income included the "grossed-up" amount of the net sum received, that is, that amount which, when reduced by the standard tax thereon, equalled the net dividend paid. In this way, standard tax was paid on corporate profits

only once, by the corporation. Therefore, to the extent that the profits were distributed as dividends, the income tax paid on them by the corporation was treated as tax of the shareholder, so that if he was exempt or entitled to some relief, he might recover the sum that he lost by way of deduction; and if he was liable to surtax, the gross dividend was assessable in common with his income from other sources. Thus, it was only the income tax on the undistributed profits which was really borne by the company. There was no similar system for passing on a company's profits tax payments.

Where a corporation, by reason of capital allowances (including investment allowances), paid no tax on its profits, it was still allowed to pay a net dividend and keep the tax. This gave the shareholder a credit for tax which the corporation had not paid. If the shareholder was an exempt taxpayer, for example, a charity, he was entitled to recover tax from the Revenue which had never, in fact, been paid. The same position applied where a corporation had a loss carried forward so that it paid no tax but was entitled under company law to distribute its subsequent profits by way of dividend. A further feature of the former law was that a corporation which had made a capital profit that was tax free could distribute that profit in a non-taxable form to the shareholders.

Reasons for the 1965 Reforms. In the opinion of the Chancellor of the Exchequer, the system for taxing corporate profits described above was deficient in the following respects: 3/

1. It did not provide sufficient incentive to companies to plough back profits for growth rather than distribute them as dividends.

2. It was unnecessarily complicated because of the existence of two taxes, income tax and profits tax, levied broadly on the same income, but according to different rules.

3. It was a patchwork system and did not stand up to the strains that resulted from the efforts of government to use the tax system for economic purposes.

4. It led to abuses and anomalies, such as recovery by companies or individuals of large sums from the Revenue by way of repayment of tax, although no corresponding sum had ever reached the Exchequer.

On a historical plane he pointed out that the method of taxing corporate profits had failed to keep pace with the fundamental changes in the concepts underlying the system which the passage of time had wrought. The British system dated back to the early nineteenth century when the incorporated company was a rarity which tended to be looked upon as a very large partnership, and income tax was a flat-rate tax applying to the incomes of companies and individuals alike. When a company paid a dividend this could be regarded as a distribution to the shareholders of profits which had already borne income tax in the hands of the company, so that no fresh assessment need be levied. Since those days, however, the personal income tax had become a graduated tax, differentiated according to the circumstances of each taxpayer; and company taxation had been altered by the introduction of a profits tax, which was imposed on the whole profits of a company. It differed from the income tax in that the company could not pass it on to the shareholder by deductions from the dividends it paid to him, and the shareholder could not claim any credit for the profits tax in his personal tax return.

According to the Chancellor, these changes made obsolete the idea that companies and individuals should be treated for tax in the same way, and to separate formally the tax on corporations and the tax on individuals was to be regarded as carrying this process to its logical conclusion.

While the changes introduced into the old tax system as it gradually developed were mainly inspired either by the wish to make it more equitable or by the need for greater revenue, the new corporation tax was introduced for essentially economic reasons. An increase in the tax burden on dividends would encourage the growth of dynamic companies by providing an incentive to them to plough back profits for growth rather than to distribute

the profits as dividends. The changes would also remove anomalies and make unnecessary some of the complicated anti-avoidance legislation of the old system.

Tax Treatment of Corporate Profits After 1965. The corporation tax system, which came into full operation on April 6, 1966, separates the taxation of companies from that of individuals. A company, that is, any body corporate or unincorporated association excluding a partnership, is liable to the new flat-rate corporation tax on its total profits at the rate of 40 per cent, but is not, in general, liable to income tax. Companies are no longer subject to profits tax. Income for corporation tax purposes is generally computed in accordance with the existing income tax legislation and relevant income tax rules. A company's gains are not charged separately to the capital gains tax but are included in the total profits on which it pays corporation tax.

Dividends Paid to Residents. Dividends and other distributions are now defined much more widely than the term "dividends" as it was formerly understood. Such dividends and distributions of a company resident in the United Kingdom paid to resident individuals are subject to income tax, which is withheld at the source under the new Schedule "F", and also in certain circumstances, to surtax, with no credit for any part of the corporation tax paid by the distributing company. The latter must account monthly to the Revenue for the tax deducted.

Dividends received by one company resident in the United Kingdom from another company resident in the United Kingdom are referred to in the new legislation as "franked investment income", and are not chargeable to corporation tax in the hands of the recipient, but are subject to withholding of income tax at the source. The income tax so deducted from franked investment income is available in the hands of the recipient company for set-off against income tax which it is in turn required to account for under Schedule "F" on its own distributions. The income tax on dividends

received is also available for repayment if offset by trading losses of the recipient but it is not otherwise repayable. When a company has an excess of franked investment income for any year over the amount of its distributions for that year, the excess may be carried forward and set against future distributions.

If a company receives other income, such as bond interest, from which income tax has been deducted, this tax is available as a set-off against the tax deducted from the dividends it pays. If this set-off is not available, the company can obtain a credit for such income tax against its corporation tax.

Dividends Paid to Non-Residents. Under the 1965 reforms, income tax at the standard rate, currently 41.25 per cent, is deductible from dividends paid by a British company to a non-resident shareholder in the absence of any other provision. Where this withholding rate is applicable, the total tax to which corporate profits paid as dividends to non-residents will be subject is currently 64.75 per cent (corporation tax of 40 per cent and standard tax of 41.25 per cent). However, the rate of withholding tax may be reduced under a double taxation agreement or under a temporary provision in the 1966 Finance Bill to the effect that the United Kingdom will only charge a withholding tax against a foreign resident to the same extent as the country of that resident charges withholding tax against a United Kingdom resident.

France

Tax Treatment of Corporate Profits and Dividends Prior to 1965. For France, as for the United Kingdom, the year 1965 marked a milestone in the evolution of its laws for the taxation of corporate profits 4/.

Until the fundamental revision of the French corporation tax structure under Law No. 65-566 of July 12, 1965, corporate profits were doubly taxed. That is to say, taxation was imposed on corporate income at a flat rate of 50 per cent, regardless of whether the profits were distributed, and dividends

were taxed in full to shareholders with no credit for any part of the corporation income tax. As a collection device, withholding tax on dividends was imposed at the source at the rate of 24 per cent. In computing taxable income, the shareholder "grossed-up" the net receipt for this withholding tax and reported dividend income at the "grossed-up" amount. After his tax liability for the year had been computed on income from all sources, the shareholder could credit the tax withheld against his final liability. If the sum withheld at source exceeded his final tax liability for the year, the excess was refunded.

Dividends received by a French resident from a foreign corporation through a paying agency, such as a bank in France, were subject to French withholding at the same rate of 24 per cent. So, too, dividends paid by French corporations to foreign shareholders were taxed at the rate of 24 per cent at the French source, although this rate might be reduced under taxation treaties with other countries.

Dividends received by a French corporation from a domestic or non-resident corporation were partially exempt from corporation income tax, the extent of the exemption varying according to the degree of ownership by the recipient of the payor's stock: the greater the percentage of ownership, the larger the exemption.

Reasons for the 1965 Reforms. This system of double taxation of corporate profits did not advance certain basic economic policies of the Fifth Republic. A major government objective is to encourage growth by stimulating investment and savings in the private sector and restraining consumption. The high tax on corporate distributions did not serve to make the ownership of shares in French corporations attractive. As M. E. Laxan, Director General of Taxation in the French Ministry of Finance pointed out, "...to transfer to the shareholder a dividend of Frs. 100, a French company would have to allocate Frs. 200 for distribution, while Frs. 130.60 are sufficient for a German corporation and Frs. 117.60 for a Belgian corporation. This double

taxation thus greatly burdened the yield of capital and went counter to the efforts of businesses to increase their own funds in resorting to the capital market." 5/ The relatively higher rates of French taxation gave rise to the fear that French capital might migrate to more attractive tax climates in neighbouring countries, and result in an artificial depreciation of French security prices, which would facilitate take-overs of French industries by foreign investors.

The corporation tax reforms of 1965 substantially lightened the tax burden on dividend income and thereby adapted the corporation tax to the requirements of the national economy and served also to harmonize the French tax system with that of the surrounding industrialized countries, especially Germany.

Tax Treatment of Corporate Profits After 1965. The new system, which becomes fully effective as of January 1, 1967, operates in the following way:

1. At the corporation level, profits will continue to be taxed at a flat rate of 50 per cent, with no differential rates for distributed or undistributed profits, such as exist under the German income tax law which is discussed below.

2. The withholding tax at source on the distribution of dividends to resident shareholders will be abolished.

3. A resident shareholder receiving a dividend will be entitled to a tax credit against his income tax equal to half the cash dividend received. In computing his taxable income, the shareholder will be required to "gross-up" his dividend and to report as income both the dividend proper and the tax credit relating thereto.

The difference in the treatment of dividends under the old system and under the 1965 reforms, which use the tax-credit technique, may be demonstrated in the following examples:

> "Before the 1965 reform, the shareholder's tax credit (24 per cent) represented (omitting special situations) an amount actually withheld from his dividend. If the corporation declared a gross dividend of 100 F per share, for example, the corporation withheld 24 F from the dividend as preliminary tax and paid the 24 F to the tax administration. The shareholder received only the balance, 76 F. In computing taxable income, the shareholder 'grossed up' the net receipt and reported dividend income of 100 F. After his tax liability for the year had been computed, on income from all sources, the shareholder received a credit (or refund) of the 24 F actually withheld at the source.
>
> "After the reform, the result will be this: if the corporation declares a dividend of 100 F a share, the shareholder will receive 100 F a share. Nothing will be withheld at the source. But the shareholder will nevertheless be entitled to a tax credit (avoir fiscal) equal to half the dividend—in this case, 50 F. Under the general principle that if A (in this case, the corporation) pays for the account of B (in this case, the shareholder) a tax legally due from B, B has enjoyed taxable income, this tax credit is considered taxable income to the shareholder. The shareholder must therefore 'gross up' his dividend by the amount of the credit, reporting as income (1) dividend proper, 100 F; (2) tax credit, 50 F; total, 150 F. Against his final income tax liability, the shareholder will be entitled to a credit (or, if he is an individual, a refund) for the 50 F—even though nothing had been withheld at the source from his dividend.
>
> "Since the corporation income tax continues to be levied at 50 per cent, the result is that half the corporation income tax imposed on the corporation earnings from which the dividend is paid is treated as though that tax had been paid for the account of the shareholder." 6/

The tax-credit system rests on the assumption that one half the corporation income tax paid by the corporation on the earnings used by it to pay the dividend is paid for the shareholder's account, and that the shareholder is entitled to claim this half by way of credit. If the shareholder is a resident individual, and the credit exceeds his tax liability on income from all sources, the excess will be refunded. The corporation is not entitled to a refund of any unused credit, nor may it carry over any unused credit to another year.

Supplemental Tax Payments. Where the amounts distributed originate from income which has not been subject to income tax at the ordinary rate, such as income derived from business carried on abroad, the basis for a shareholder tax credit is wanting. However, on administrative grounds it was

decided to grant shareholders the usual credit of 50 per cent of the dividend, and to require the distributing corporation to make a supplementary tax payment in the same amount, that is, one half the dividend. This procedure allows all dividends, without regard to their origin, to benefit from the tax credit and also avoids the complications attached to a system which recognizes two types of dividends.

A corporation is also required to make the supplementary tax payment in the amount of 50 per cent of the dividend if the dividend is paid out of profits earned during fiscal years which ended before January 1, 1965, or out of profits earned by the corporation during a fiscal year which closed more than five years before the year of distribution. The rationale here is to encourage the prompt distribution of earnings.

<u>Dividends to Non-Residents</u>. The benefit of the tax credit is reserved to French residents. After January 1, 1967, there will be no withholding from French dividends to French resident shareholders, but withholding of tax from French dividends to non-resident shareholders will be increased from 24 per cent to 25 per cent. Therefore, the effective total tax on non-residents is 62.5 per cent. The purpose of this treatment of non-residents is to encourage investment by Frenchmen in France, and it greatly favours the resident as against the non-resident. The rate of withholding is, of course, subject to tax treaties between France and the country of the shareholder's residence.

<u>Dividends from Foreign Corporations</u>. The French withholding tax on a dividend distributed by a foreign corporation to a resident of France and collected when the dividend is cashed in France, is increased from 24 per cent to 33.33 per cent, although the taxpayer will be entitled to a tax credit of 50 per cent of the net dividend receipt. For example, an individual shareholder receives a foreign dividend of 1,200 F through a French bank. The bank withholds 33.33 per cent or 400 F. The shareholder receives a net dividend of 800 F, but must gross-up the dividend to 1,200 F for the

computation of his income tax. The credit to which he is entitled is one half of 800 F (the net dividend) or 400 F. Thus, the increase to 33.33 per cent does not increase the tax ultimately due with respect to the dividend, but simplifies the procedure for filing returns because this credit will in effect be equal to one half of the net dividends received, as in the case of domestic dividends.

Germany 7/

Split-Rate Tax on Corporation Profits. Resident commercial corporations, which may take a variety of forms of commercial law entities, such as the stock corporation, the limited liability company, and the partnership limited by shares, are taxed at the rate of 51 per cent on their undistributed profits and at the rate of 15 per cent on the portion of their profits paid out as dividends if the distribution is in the nature of a "qualifying distribution", which is discussed below.

Reasons for the Split-Rate System. The introduction of a split rate of corporation tax in the mid-1950's was prompted by certain domestic economic objectives of the federal government. First, to encourage a more liberal dividend policy on the part of domestic corporations so as to promote a wide distribution of property ownership through the popularization of share ownership, in addition to the encouragement of home building and regular savings. Second, to reduce to a more normal level self-financing through the retention and ploughing back of profits in the business 8/.

The split rate of corporation income tax has not led to an appreciable reduction in the rate of profits retention in German industry, although it has probably prevented it from growing. However, it has provided a reduction of the burden of double taxation on corporate profits, providing relief at the corporate level rather than at the shareholder level 9/.

Qualifying Distributions. Not all types of corporate distributions are eligible for taxation at the 15 per cent rate. It is in fact limited to a

dividend in the nature of a "qualifying distribution", which is a distribution of profits made by a resident corporation pursuant to a formal resolution passed in conformity with the rules of the commercial law, and made for a business year whose results are considered in the assessment of the year for which the distribution is made. Hence, constructive dividends, that is, benefits other than dividends which a corporation distributes to its members by reason of their capacity as members, cannot be the subject of a qualifying distribution because they are not paid pursuant to a formal dividend resolution. Excluded are such benefits as the payment of an excessive salary to an officer who is also a shareholder; a loan made by a company to a shareholder free of interest or at a low rate of interest; a loan by a shareholder to a company at a high rate of interest; a sale between a company and a shareholder at an unusual price or on unusual conditions; and the cancellation of a valid claim against a shareholder by a corporation. The split rate effectively penalizes such constructive dividends by subjecting them to the full rate of 51 per cent. The limited application of the lower tax rate reflects the intention of the government to restrict the relief from double taxation to those distributions which, like dividend payments, stimulate the development of the capital market.

Once the income realized by the corporation in its last preceding business year has been computed, the tax rate to be applied depends on the amount of the qualifying distribution, which is determined by the annual meeting of shareholders who are obliged by law to decide on the disposition of profits of the preceding business year. This disposition can be made, in general, in one of three ways. The general meeting can decide to distribute the profits to the shareholders, to carry them forward to the next following business year as unappropriated surplus, or to assign the profits to a reserve. Only dispositions of the first-named type benefit from the reduced tax rate applying to distributed profits. Profits assigned to surplus or to a reserve are taxed at the full corporation income tax rate.

It is important to note that a distribution from the profits of a given business year can be a qualifying distribution for that year only, with the result that when retained earnings which have borne income tax in earlier years at full corporate rates are distributed, a re-assessment in respect of those years with the object of claiming the reduced rates for the earnings then retained but subsequently distributed is not possible 10/. Hence, if a corporation wishes to take maximum advantage of the reduced rate, it must distribute currently all of its profits for a business year.

Dividends Paid to Resident Shareholders. Two different situations apply in the case of dividends paid to resident shareholders.

1. In general, resident individual and corporate shareholders are subject to withholding of income tax at source in respect of dividends paid by German corporations. The taxpayer can claim a credit or refund of the withholding tax when the tax assessed for the year of distribution is less than the amount of the tax withheld. The rate of the withholding tax is 25 per cent of the gross amount of the distribution if the tax is borne by the recipient, or 33.33 per cent of the amount actually paid out if the tax is borne by the distributing entity. If a dividend is paid in property, the withholding tax is computed on the price which the recipient would have to pay for similar property at his domicile under normal conditions.

   Withholding of income tax at the source is required not only for dividends and other formal distributions of profits, but also for payments or other benefits which a corporation makes available to its shareholders in addition to, or in lieu of, dividends. The principal example of such distributions is constructive dividends, some of which are described above. The tax rate of 33.33 per cent always applies to these distributions, because the tax is borne by the distributing entity.

2. Dividends received by a resident corporation from another resident corporation are excluded from the taxable income of the recipient if the recipient (the holding company) owns 25 per cent or more of the issued share capital of the distributing entity (the affiliated company). The exemption applies only to the extent that the recipient corporation in turn distributes the dividend received to its own shareholders. Otherwise, the recipient corporation becomes liable for the payment of a "supplementary tax", the rate of which is equal to the difference between the corporation income tax rate on undistributed profits and the tax rate on distributed profits, that is, 51 per cent minus 15 per cent, or 36 per cent.

The purpose of the supplementary tax is to prevent affiliated companies from shifting profits from one member of the group to another without ever paying tax on the profits at the full corporate rate and without making a distribution to individuals. Otherwise, an affiliated corporation would have a real tax advantage over other corporations because it could distribute its profits to the holding company and pay tax at only 15 per cent, and the holding company could reinvest the amount distributed in the affiliated company without further taxation, whereas other corporations would have paid tax at 51 per cent on profits retained in the business.

Dividends Paid to Non-Residents. Dividends paid to non-residents on shares of a corporation having its domicile, seat, or place of management in Germany, are subject to withholding tax at source. The tax liability of the non-resident is finally settled with payment of the withholding tax, the rates of which are 25 per cent of the gross amount of the distribution if the tax is borne by the non-resident, or 33.33 per cent of the amount actually paid out if the tax is borne by the distributing corporation.

Dividends Received from Foreign Corporations. Individuals and corporations resident in Germany are taxed on a world-wide basis. Hence, dividends

received from foreign corporations are included in income in the same manner as domestic dividends. Where the recipient is a corporation, the corporation income tax rates on undistributed profits or those on distributed profits apply, depending on whether the dividend is retained by the recipient or redistributed to its own shareholders.

United States 11/

The Corporation as a Taxable Entity. Corporations are, in general, treated as separate taxable entities under the federal income tax. Thus, a corporation is required to determine its annual taxable income on the basis of the activities which it carried on during the taxable year, and to pay a tax on such income, quite independently and apart from the activities and tax obligations of its shareholders. The shareholders are likewise independent of the corporation for income tax purposes because the corporate earnings are taxed only to the corporation and are not included in the income of a shareholder until distributed as dividends or in some other form.

The Internal Revenue Code contains a special rate structure which is applicable to corporations only. At the present time, corporations are taxed at the rate of 22 per cent on the first $25,000 of income and at 48 per cent on the balance. The taxable income of a corporation is computed in much the same manner as that of an individual.

Dividends Paid to Residents. A dividend for tax purposes is any distribution made by a corporation to its shareholders out of its earnings and profits. However, a distribution in complete or partial liquidation of the corporation is treated as a sale of the stock and any gain is taxed at the reduced capital gains rates. Under certain circumstances which involve a continuity of business interests in new corporate forms, a shareholder may exchange his shares for stock in a continuing enterprise without recognition of taxable gain or loss 12/.

A dividend represents gross income to the shareholder and is subject to tax at the regularly applicable rates. Because a corporation cannot

deduct from its gross income the amount of the dividends distributed to its shareholders during the taxable year, any distributed earnings are necessarily taxed twice: at the corporate level when included in the corporation's taxable income, and again at the shareholder level when received as a dividend. This two-level taxing arrangement has been a fixed characteristic of the federal revenue system for many years, but has been subject to recurring criticism on the ground that it unfairly discriminates against persons doing business in corporate form. The quantum of corporation income tax that is passed on in the form of higher prices is open to debate by economists. In the case of an individual shareholder, a degree of relief is provided by the exclusion of the first $100 of dividends received from domestic corporations. Until 1964, the exclusion was $50. Individual shareholders were also entitled to a 4 per cent dividend tax credit which was reduced to 2 per cent for 1964 and eliminated entirely for 1965 and subsequent taxation years. This credit was eliminated on the grounds that it gave undue relief from double taxation to high bracket shareholders as compared to low bracket shareholders and that rate reductions were a more equitable solution to the problem.

In the case of a corporate shareholder, a deduction is allowed for 85 per cent of all dividends received from domestic corporations. Affiliated groups defined as parents and at least 80 per cent owned subsidiaries, may achieve a 100 per cent intercorporate dividend deduction by a special election or by filing a consolidated return. Without some elimination, successive taxation of the dividend as it passed from corporation to corporation in a chain of corporations would result in repeated taxation of the same income and would leave very little for the ultimate individual shareholder.

Dividends Paid to Non-Residents. Dividends paid to non-resident aliens not engaged in trade or business within the United States at any time during the taxable year and the amount of whose fixed or determinable annual or periodic income from United States sources, plus taxable excess capital gains from

United States sources, is $21,200 or less are subject to withholding tax at a flat rate of 30 per cent. If their income is in excess of this amount, they are taxed under the regular rates of the individual income tax, that is, the progressive rates of the individual income tax; and the special reduced rate on capital gains is applicable, rather than the 30 per cent flat rate. In many cases, however, the withholding rate has been reduced by treaty. Changes in these provisions were under consideration at the time of writing as part of a programme to encourage non-resident investment in the United States.

REFERENCES

1/ Royal Commission on the Taxation of Profits and Income, Final Report, London: H.M.S.O., 1955, Cmd. 9474, p. 155.

2/ Finance Act, 1958, Chapter 56, section 25.

3/ See Hansard, Parliamentary Debates, Vol. 701, November 11, 1964, col. 1941, and Vol. 710, April 6, 1965, col. 254. The economic reasons underlying the enactment of the corporation tax are discussed by the Rt. Hon. James Callaghan, M.P., Chancellor of the Exchequer, in an article, "The New United Kingdom Tax Structure in Relation to the Needs of the Economy", (1965) 5 European Taxation 212.

4/ For a detailed discussion of the pre-1965 laws and the 1965 reforms, see Harvard Law School, Taxation in France, World Tax series, Chicago: Commerce Clearing House, 1966, and M. Norr, "The French Reform of Dividend Taxation and Common Market Tax Harmonization", (1966) 44 Taxes—The Tax Magazine 320.

5/ "The Recent Evolution of the French Tax System", (1965) 5 European Taxation 264, p. 265.

6/ M. Norr, op. cit., footnote 4, pp. 323-24.

7/ For a detailed discussion of the taxation of corporate profits in Germany, see Harvard Law School, Taxation in the Federal Republic of Germany, World Tax Series, Chicago: Commerce Clearing House, 1963, and Rädler and Edwards, "The Split Rate of Corporation Income Tax in Germany —A Taxation Advantage for Foreign-Owned Subsidiaries" (1963), C.C.H. Common Market Reports, Transfer Binder, section 9051.

8/ The latter economic objective is, of course, precisely the opposite of the new United Kingdom corporation tax which is intended to encourage the ploughing back of profits by placing a heavier tax burden on distributions.

9/ See Rädler and Edwards, op. cit., footnote 7, pp. 7764-65 and 7769.

10/ There is an indirect way in which this aim can be achieved provided the enterprise is currently earning a taxable profit. See Rädler and Edwards, op. cit., footnote 7, pp. 7761-62.

11/ For a detailed discussion of the tax treatment of corporate profits and dividends under United States income tax laws, see Harvard Law School, Taxation in the United States, World Tax Series, Chicago: Commerce Clearing House, 1963.

12/ The tax treatment of the many forms of corporate distributions to shareholders is exceedingly complex. The problems all trace back to the separation of shareholder and corporation and the desire of shareholders to obtain the earnings from the corporation as capital gains, which are subject to reduced rates of tax. Ibid., pp. 715-864.

APPENDIX H

ACCOUNTING AND REPORTING PROCEDURES FOR THE INTEGRATION OF CORPORATION AND PERSONAL INCOME TAXES

Since the proposal contained in the Report for the integration of corporation and personal income taxes is a major departure from the present tax system, it is essential to set forth in some detail a description of procedures which could be followed in its operation. While this appendix will repeat some material already contained in Chapter 19, it should help to explain the more technical aspects of the proposal.

However, it should be emphasized that this appendix does not attempt to illustrate how all the potential problems in the proposal would be met. Instead, it gives a number of examples of situations that might be thought to pose major difficulties, but in fact can be fairly readily resolved within the general framework of the integration proposal. Many technical difficulties were raised when the integration proposal was examined by the Commission and its research staff. In all cases it was possible to develop procedures to resolve what at first had appeared to be serious problems. This does not mean that all the possible problem areas have been dealt with, but it does mean that in all those examined the difficulties were resolved. This appendix then is a brief review of some of these situations and how they might be dealt with.

BASIC ELEMENTS OF THE PROPOSAL

The basic objective of the integration of corporation and personal income taxes is to enable the income of Canadian residents derived through corporations to be taxed at personal rates. Integration is achieved by regarding the income of a corporation as income of its shareholders and the income tax paid by the corporation as having been paid on behalf of its shareholders, so that upon a distribution or deemed distribution to a shareholder the corporation income tax is assumed to have been paid on his behalf and the amount of the distribution (or deemed distribution) plus such corporation tax represents the income to be taxed at his personal rate. If a Canadian

shareholder sells his shares before the income, accrued during his period of ownership, is distributed or deemed to be distributed, it is assumed that in his selling price he will attempt to recover (among other things) the amount of income so accrued before corporation tax. With the full taxation of share gains, the amount he recovers will be taxed at his personal rate. As will be illustrated later in this appendix, the purchaser should be able to pay such a price because he will be entitled to the credit for the corporation tax when the distribution takes place.

Regular Types of Distribution or Allocation
Which Would Carry a Tax Credit

As is indicated in Chapter 19, there would be four procedures by which credit for corporation tax could be passed to shareholders, three of which, dividends in cash or in kind, stock dividends and other capitalizations of surplus, would follow the regular corporate procedures. The fourth would be an allocation of undistributed income for tax purposes without a legal capitalization. Except where otherwise specifically stated, the first three procedures will be included in any subsequent use of the word "distribution", and the fourth will be referred to as an "allocation".

The shareholder would not report as income the amount of the distribution or allocation, which would be calculated on the after-tax income of the corporation, but rather the amount of the distribution or allocation plus the amount of the credit for the corporation tax 1/. In practice, this grossing-up of the distribution or allocation would be calculated by the issuing corporation, and the shareholder would merely be informed of the income to be reported, the tax which could be claimed as a credit, and the net amount of the distribution or allocation 2/. The shareholder would then be taxed on the grossed-up amount at his personal rate and would receive credit for the corporation income tax paid. If the credit exceeded his personal tax, he would receive a refund of the excess. The procedure could therefore be compared with the treatment of employment income at the present

time, which requires the inclusion in income of the amount of taxes already paid on behalf of the employee.

Cash Dividends. If \$50 was paid out to a shareholder as a cash dividend and the rate of tax credit was 50 per cent, the grossed-up amount of the dividend to be included in income would be $\frac{100}{100-50}$ x \$50, or \$100, and the shareholder would report it as follows:

	Shareholder's Tax Bracket		
	10%	30%	50%
Shareholder's income	\$100	\$100	\$100
Shareholder's tax liability	(10)	(30)	(50)
Corporation tax credit	50	50	50
Net tax refund to shareholder	\$ 40	\$ 20	-

When the net tax refund was added to the cash dividend actually received, the total proceeds to the shareholder would equal the grossed-up income less the shareholder's tax rate applied thereto:

	Shareholder's Tax Bracket		
	10%	30%	50%
Net tax refund, as above	\$40	\$20	-
Actual cash dividend received	50	50	50
Total received by shareholder	\$90	\$70	\$50

The foregoing examples would also be applicable where a corporation paid a dividend in kind rather than in cash.

Capitalization of Earnings. Where a corporation paid a dividend in its own shares rather than in cash, the procedure would be similar to that for a cash dividend in that the amount of the stock dividend would be grossed-up to include the corporation tax credit, and the shareholder would report the grossed-up amount as income and claim the credit for the corporation tax. However, to reflect the capitalization of earnings by the corporation, the shares issued as a stock dividend would have a cost basis equal to the amount

of the stock dividend. When these shares were later sold, the portion of the price representing the capitalized earnings would then not bear further tax. If the shareholder did not recover the amount of the capitalized earnings upon subsequent sale, there would be a deductible loss on the shares.

The same procedures would be followed where earnings were capitalized by some corporate action without a stock dividend. For example, capitalization would occur where earnings were appropriated to the capital stock account of no par value shares of a particular class. The amount capitalized and added to the cost basis would then be spread over the issued shares of that class. The amount attributed to a particular shareholder would be included in his income and grossed-up to include the tax for which he would receive credit.

Allocation of Earnings. While a stock dividend or other form of capitalization procedure would involve the actual transfer of after-tax surplus to the capital stock account and therefore a change in the legal form of the capital structure of the corporation, the allocation procedure contemplated here would be a method of integrating corporation and personal income taxes without any change in the capital structure. The allocation would be effective for tax purposes only. The objective of the allocation would be to enable the corporate earnings to be taxed at the individual income tax rates of Canadian shareholders, without requiring a stock dividend or other capitalization procedure and without affecting non-resident shareholders. A Canadian shareholder would then report the grossed-up corporate income allocated to him and claim a credit for his proportion of the corporation tax already paid on that income.

The actual procedure to be followed would require the directors to determine the amount to be allocated, and the information slip sent to the shareholder at the end of the year would reflect this amount in the same way as it would reflect the declaration of a stock dividend, even though the after-tax earnings retained would remain as surplus and would not be legally

capitalized. Thus, as in the case of non-cash distributions, the share cost basis would be increased by the amount of the after-tax earnings allocated to the shareholder. If this income was subsequently distributed, a resident shareholder would treat the amounts distributed to him as a return of capital and would reduce the cost basis of his shares.

This procedure would be quite simple where there was only one class of shares, or where the classes of shares participated equally in earnings and on liquidation (although the voting rights may differ), or where any additional classes of shares were only eligible to receive a fixed and preferential dividend and did not have a residual participation in earnings. However, where there were two or more classes of shares and the ratio in which the classes would participate in earnings varied from time to time or was different on liquidation than on the distribution of dividends, it would probably be necessary to have restrictive provisions to ensure that it would not be possible to defer or avoid tax by permitting an allocation to the holders of one class of shares of amounts which would subsequently be distributed to the holders of another class of shares. We reviewed the capital structures of most of the publicly traded companies and found very few examples that currently could lead to this kind of difficulty. Therefore, legislation to limit allocations when there were two or more classes of shares outstanding that participated to a different extent in profits and on liquidation would inhibit the actions of only a few companies. A corporation which was unduly restricted by the legislation could revise its capital structure so as to be able to take advantage of the allocation procedure. This could be done without adverse tax consequences, having regard to our proposals in Chapter 15 with respect to corporate reorganizations.

Where income was allocated to one shareholder and was later distributed to another person who had subsequently acquired the shares, there would ordinarily

be no deferment or avoidance of tax because of the proposed full taxation of capital gains and full allowance of losses. This is explained more fully later in this appendix. However, if the shares were sold at an artificial price, either in a non-arm's-length transaction or under an option or other agreement, there might be such a deferment or avoidance, particularly if the transaction was between a resident and a non-resident. This problem would exist in the case of a capitalization of surplus, particularly a capitalization which did not involve a stock dividend, as well as in the case of allocations. In Chapter 19 we have suggested some provisions with respect to allocations which should prevent most such avoidance and deferment of tax. Similar provisions may also be necessary with respect to capitalizations.

Other Types of Distribution

The types of distribution or allocation described above would be the usual methods used to pass credit for the corporation income tax to Canadian shareholders. Under the present tax system, additional tax is usually exigible on all corporate distributions, and accordingly the legislation is drafted in such a way as to ensure that anything which could amount to a distribution of income is taxed. However, under the proposed tax system, distributions of corporate income to residents would ordinarily result in no further tax and in many cases a refund of tax. This change in emphasis suggests that the legislative approach to defining what constituted a distribution of income could be more restrictive. Possibly only certain described types of distribution would be permitted to carry a tax credit.

However, there would be instances where additional tax would be payable upon a distribution of surplus by the corporation. For resident shareholders this could arise in respect of distributions of income untaxed to the corporation because of incentive legislation but taxable on distribution. Similarly, if the corporation had foreign direct investment income, under our proposals in Chapter 26 an additional tax would be payable on distribution.

In Chapter 19 we have suggested the tax treatment which we consider should apply in the case of the most common types of distribution. However, this would have to be considered carefully when drafting the legislation.

Non-resident shareholders would not be affected by allocations of income and would continue to be subject to withholding tax on distributions. The present provisions for determining the taxability of distributions to non-residents seems appropriate and should be continued in substantially its present form, subject to our recommendations in Chapter 26.

Sale of Shares Before
Distribution or Allocation

This section describes how integration would operate if the shareholder sold his shares after income had accrued but before it had been distributed or allocated.

The shareholder who was selling his shares would wish to obtain a price which, in respect of earnings to date, would give him the same result as if he had waited for the distribution or allocation. As is indicated above, if he waited to receive a distribution or allocation he would obtain a benefit measured by reference to the corporation income before tax less his personal tax thereon. Because share gains would be fully taxable, he would therefore expect his selling price to reflect the before-tax corporate income accrued and not distributed or allocated at the time he sold the shares.

Assume that an individual purchased a share for $1,000 and held it for a year, during which time his share of the before-tax corporate income accrued but not distributed amounted to $100. If he was going to sell his share he would wish to obtain a price equal to the same amount after tax as

if a distribution had been made. Because on a distribution he would recover $100 less his personal tax, he would seek to sell his share at a price of $1,100, which would equal his original investment of $1,000 plus the corporate income before tax.

For his part, the potential purchaser would expect to pay no tax and possibly to obtain a refund of tax on the forthcoming distribution.

	Tax Bracket of Purchaser		
	10%	30%	50%
Income distribution (grossed-up)	$100	$100	$100
Personal tax	10	30	50
Corporation tax credit	(50)	(50)	(50)
Net tax refund or credit	$(40)	$(20)	$ -

However, if as a result of the distribution, the value of his share decreased by $100 and if he resold it immediately for $1,000, the loss of $100 would be deductible and would "wash" out the income distribution. In the end result, he would obtain a refund of the full corporation tax on the income accrued in the purchase price.

	Tax Bracket of Purchaser		
	10%	30%	50%
Tax refund on distribution, as above	$ 40	$ 20	$ -
Tax reduction from loss of $100 on resale of share	10	30	50
Total tax refund or credit	$ 50	$ 50	$ 50

Another way to illustrate the overall result for the purchaser is as follows:

	Tax Bracket of Purchaser		
	10%	30%	50%
Income distribution (grossed-up)	$100	$100	$100
Loss on sale of share immediately after distribution	100	100	100
Income for tax purposes	-	-	-
Corporation tax credit	50	50	50
Cash dividend	50	50	50
Total proceeds, equal to price paid for the undistributed income and equal to loss on resale of share	$100	$100	$100

Under these conditions the purchaser could therefore pay a price which included the corporate income before tax and the corporate income reflected in the sale price would have been taxed at the rate of the individual who owned the share during the period the income accrued. However, it can be argued that ordinarily the conditions assumed above would not exist. The purchaser might not know the amount and time of the next distribution, and might not intend to resell the share in the near future. More important, the market price of the share would depend so much on other factors, such as expected earning power, that it would not merely reflect earnings to date. Nevertheless, an equitable tax result should also obtain under these conditions.

Assume that the selling price of the share was not $1,100, but rather $1,070, and that, as before, the purchaser later received a distribution of $50 and resold the share for $1,000. Assume further that the tax brackets of the selling and the purchasing shareholders were 30 per cent and 10 per cent respectively. The total tax collected on the $100 of corporate income would then be as follows;

From the Corporation		
Income of $100 taxed at 50 per cent		$50
From the Selling Shareholder		
Gain on sale of share	$70	
Personal income tax at 30 per cent		21
From the Purchasing Shareholder		
Income distribution (grossed-up)	$100	
Loss on resale of share	(70)	
Taxable income	$30	
Personal income tax at 10 per cent	$ 3	
Credit for corporation income tax	(50)	(47)
		$24

Because the $100 of income bore a tax of $24 even though it was earned during ownership by a shareholder in the 30 per cent bracket, it might appear that the income was undertaxed. However, the fact of the matter is that the 30 per cent shareholder only realized $70; a profit equal to the remaining $30 was realized by a taxpayer in the 10 per cent bracket and the total tax was therefore reduced by $6. Whether the income should have been realized by these individuals in this way is not relevant to the tax system; the important thing is that the tax was imposed equitably on the gain finally realized by each individual.

This illustration demonstrates that the taxation of the income of the corporation is only an interim step to the taxation at personal rates of the gain actually realized by the individual Canadian shareholder. With the full taxation of share gains and full deduction of share losses, combined with a full credit for the corporation tax, such a result can be achieved.

It is true that temporary overpayments of tax would occur in two different sets of circumstances. First, a delay between the sale of a share and the distribution or allocation of income which was included in the price

of the share would result in overpayment, for in that interval both corporation and personal income taxes could have been paid on the same income. However, with a high level of distribution or allocation, this delay would usually be for less than a year and the temporary overtaxation should not be serious. As already explained in Chapter 19, far from inhibiting a high level of distribution or allocation, the proposed system would encourage it.

In the second place, temporary overpayment of tax would arise from a lapse of time between the distribution or allocation of the income to the purchasing shareholder and the subsequent resale of the shares. During that period personal income tax would have been charged to the purchaser on an amount of corporate income, even though this income was reflected in the purchase price of the shares and accordingly when distributed it could be said to represent a recovery of part of the purchase price. The offsetting reduction in personal income tax would not take place until the share was resold. At the same time as the purchaser was waiting for a deduction for the loss in share value in this respect, he would not, of course, have to accrue offsetting increases in the value of his shares. If there were no such offsetting increases and if he chose to revalue his shares as proposed in Chapter 15, he would not have to await the time of disposal for recognition of the loss.

It therefore appears that the income of corporations accruing to resident shareholders can be taxed in an equitable manner, particularly where the shares are publicly traded and there is an established market value for them. Furthermore, this process does not require that corporate income and corporation tax thereon be identified with the shareholder who owned the shares at the time the income accrued.

For resident shareholders, the achievement of the desired objective depends on the full taxation of share gains, the full deduction of share losses and a full credit for the corporation income tax. However, where non-resident shareholders are involved, the conditions change. It does not

seem practicable for Canada to tax share gains realized by non-residents. However, it would be of concern to the Revenue if the corporation tax on income which accrued to non-resident owners was actually refunded upon subsequent distribution of the income to residents who purchased the shares. This avoidance problem is discussed in Chapter 19 and recommendations are made there to resolve it.

Sale of Shares After Allocation
But Before Distribution

Shareholders would often sell their shares after income had been allocated to them but before it was actually distributed. The shareholder to whom the allocation was made would include the allocation in his income on a grossed-up basis and would obtain credit for the corporation income tax. The purchaser would receive a distribution out of the amount previously allocated and would not include this distribution in his income but would treat it as a realization of capital, that is, as a reduction in the cost basis of the shares. Accordingly, the amount which he received on the distribution would be added to the profit which he would make on the eventual disposition of the shares. However, if he purchased the shares at their fair market value, which took into account the previously allocated income, there would not be an undue deferment of tax liability.

Assume that a corporation with one shareholder had paid-up capital of $100 and earned profits of $1,000 which had been subject to corporation tax of $500. Assume also that the remaining after-tax income of $500 was allocated to the shareholder, and that he then sold the shares for $600, which was equal to the book value of the assets of the company. The position of the vendor would be as follows:

	Tax Bracket of Vendor		
	10%	30%	50%
Income allocation (grossed-up)	$1,000	$1,000	$1,000
Personal tax	$ 100	$ 300	$ 500
Less corporation tax credit	500	500	500
Net tax refund or credit	$ 400	$ 200	-
Proceeds from disposal of shares	$ 600	$ 600	$ 600
Less original cost of shares	100	100	100
Less increase in the cost basis on allocation	500	500	500
Gain or loss on sale	-	-	-

Assume that after the sale was completed the corporation distributed its after-tax income of $500. The position of the purchaser would be as follows:

Cost of shares	$ 600
Less return of capital on distribution of previously allocated income	500
Revised cost basis	$ 100

If the shares had been transferred at an artificially low price, for example at $300, the vendor would have realized a loss of $300 on the sale. In the absence of special provisions, he would have been entitled to deduct this loss from other income. The purchaser would have acquired the shares at $300 and would then have received a distribution of $500 by way of a return of capital. This would have resulted in $200 being included in his income and the cost basis of his shares being reduced to zero. Accordingly, tax on an amount of $100, which would have been the value of the shares following the distribution, would have been deferred. This is equal to the difference between the loss claimed by the vendor ($300) and the amount included in the income of the purchaser ($200). The following rules should be applicable in these circumstances:

1. If the shares were transferred in a transaction which was not bona fide and at arm's length, the transfer should be deemed to have taken place at the fair market value, and the vendor should then be deemed to have made a gift to the purchaser equal to the difference between the fair market value and the sale price. Accordingly, in the last example, the sale would be deemed to have taken place at $600 and the vendor would not be entitled to deduct the loss arising on the sale. The purchaser would be in the same position as if the shares had been purchased for $600, but in addition he would be required to include a gift of $300 in his income.

2. If shares owned by a resident shareholder were acquired by another resident under an option or agreement in an arm's length transaction at a price that was less than their fair market value, the purchaser on acquiring the shares should be deemed to have disposed of them immediately at the fair market value and to have then reacquired them at the same price. The purchaser would then be immediately subject to tax upon the profit which arose on the exercise of the option or on the completion of the agreement ($600 less $300), which would be the amount of the loss deducted by the vendor. Upon receiving the distribution of $500, his cost basis would be reduced to $100, which would be the assumed value of the shares. In this example, it is assumed that the fair market value of the shares would be the same as the book value of the assets. If this was not the case, the application of this rule would nevertheless give a reasonable and consistent result for tax purposes.

3. If the purchaser was a non-resident who acquired the shares under an option or agreement or other right, the tax position of the vendor should be adjusted so that allocations made to him while the non-resident had a right to acquire the shares less amounts distributed to him during that period as a return of capital would be disregarded for tax purposes. If there was a firm agreement for the sale to a non-resident,

these allocations should be disregarded in the first place, since the non-resident would be in effect the beneficial or equitable owner of the shares. If a non-resident had an option to acquire the shares, the accounts of the vendor should be adjusted only when the option was exercised, since until then it would not be known whether the option would be exercised. However, if the option was exercised, interest should be charged on the net tax refunds or credits which had been obtained by the vendor while the option was outstanding. A person whose shares were under option to a non-resident should have the right to leave the amount of such net refunds or credits on deposit with the government to avoid such interest being charged.

Suppose that in the above case, when the corporation was originally formed a non-resident obtained an option to acquire the shares for $300 and that this option was exercised after the corporation had earned before-tax income of $1,000. After adjustment under the rule outlined above, the position of the vendor would be as follows:

Cost basis to vendor (unadjusted by allocations)	$100
Personal tax	-
Corporation tax credit	-
Sale price	300
Gain on sale	$200

This gain would be subject to tax at the vendor's personal rate. No credit would be allowed for the corporation tax, this being consistent with what the position would have been if the non-resident had owned the shares throughout the period. However, if the vendor had received a taxable dividend during the period, it should be included in his income on a grossed-up basis and he should receive credit for the corporation tax in the same way as any other resident, since he would have enjoyed the benefit of that income. This treatment should also apply

to any amounts allocated to him which were subsequently actually distributed to him as a return of capital, since this combination of events in substance would be equivalent to the payment of a cash dividend.

The rules referred to above would also be necessary in the case of a capitalization since it would have the same effect for tax purposes as an allocation.

A METHOD OF ACCOUNTING AND REPORTING

A variety of procedures is available for recording transactions under the proposed integration of corporation and personal income taxes. The procedure actually adopted would depend on the purposes to be served and on practical considerations such as convenience and enforcement. The purpose of the following exposition will be to demonstrate <u>one</u> method of dealing with some of the circumstances which are likely to arise. Improvements could be made after further study and experience, and limited variations might be necessary to accommodate particular incentive policies of the government.

Certain basic alternative methods would be available for accomplishing the integration of the two levels of tax, and the choice of method would affect the accounting procedures to be followed by the corporation and the nature of the reporting to shareholders. One method would involve tracing through to the shareholder the various sources from which the distribution was made, such as regular income taxed at the full corporate rate, income taxed at incentive rates and foreign direct investment income 3/. Such a procedure would give the shareholder detailed information about the sources of the corporation's income, and might enable certain objectives of the tax system to be carried through to the individual shareholder. For example, foreign direct investment income could be taxed at the individual rate of the shareholder with a credit for the actual or deemed foreign tax paid, or income eligible for an incentive could be taxed at a reduced personal rate.

However, such a procedure would obviously require complex accounting and detailed reporting to the shareholder and would probably create compliance problems.

Another alternative would be to combine the various sources of the distribution, which may have been taxed at different rates or not taxed at all, to calculate the average rate of tax paid, and to report to the shareholder a combined amount of income on which the average rate of tax could be claimed as a credit by the shareholder. The rate of tax credit applicable to distributions would then vary from one corporation to another, depending on the particular mix of various types of income. In addition, any material difference between the tax rate based on final assessment and the estimated rate reported to shareholders for tax gross-up and credit purposes would imply a reopening of shareholders' tax returns 4/. This would not be practical. Consequently, shareholders of different classes and successive holders of the same shares could be materially affected by any inaccuracies in a corporation's first estimate of the tax rate. This would place too high a premium on tax estimates. Moreover, it could give rise to manipulations as well as errors.

We think it is important that corporate distributions and allocations should carry a uniform rate of tax credit, equal to the current statutory rate of corporation tax. The simplest way of achieving this would be to treat every allocation and every distribution other than a return of capital as carrying a tax credit at the current rate of corporation tax and to control the tax credits passed to shareholders by keeping a record of the corporation tax paid by the corporation. While this method is fairly simple and should operate satisfactorily, it presents some problems. Distributions or allocations out of some types of income which had not borne tax at the full rate, such as income from foreign direct investment, would necessarily be subject to a further tax on distribution or allocation to the shareholders. Furthermore, certain distributions, such as a dividend out of financial surplus, where there was no surplus for tax purposes, might better be treated as a reduction of the cost basis of shares than as income.

The accounting and reporting procedures which follow should not be read as precluding the adoption of an alternative procedure. Their primary purpose is to demonstrate that modifications can be made which will meet these problems and yet at the same time maintain a uniform rate of tax credit for the shareholder.

We would expect that the provisions could be designed in such a way that there would be basically two types of distributions:

1. Distributions of income which had been subject to corporation tax (or were deemed to have been subject to corporation tax) when earned or, in some instances referred to above, at the time of distribution. These distributions would be included in the incomes of the shareholders on a grossed-up basis and credit would be allowed for the corporation tax as outlined above.

2. Distributions which represented a return of capital. These would include distributions made on a redemption of shares, dividends paid out of income previously allocated but not distributed and distributions out of surplus accrued as at the effective date of the legislation or out of any other financial surplus of the corporation. Such distributions would not be included in the shareholder's income but would be applied to reduce his cost basis of the shares. If any such distribution should exceed the cost basis of the shares the excess would be included in his income.

By their very nature, all allocations would be from income as described in 1 above. Later in this appendix we discuss the order in which these types of distributions would be made.

Accounting by the Corporation

The financial accounts and the financial statements of the corporation would be along much the same lines as at present, with the corporation income

tax being a deduction in arriving at both the final amount of income for the year and the accumulated surplus. Additional accounts could be provided, and the balance reported, 5/ largely for the information of shareholders and investors generally, so that they would be aware of the tax status of surplus and the tax credits available in respect of future distributions or allocations.

The additional accounts to be maintained by the corporation might include the following:

1. A record of the income of the corporation subsequent to the effective date of the legislation which had been subject to corporation tax at the full rate and which had not been allocated or distributed to shareholders. This would be the grossed-up income applicable to the Corporation Tax account referred to below. This account will be referred to as the Taxed Income account.

2. A record of corporation tax payments at the full corporate rate which were available as a credit to shareholders upon distribution or allocation. This account will be referred to as the Corporation Tax account.

3. A record of untaxed income which, under incentive legislation, was not to be taxed at the corporate level but was to be taxed in whole or in part upon distribution to shareholders. This account will be referred to as the Incentive Income account.

4. A record of foreign direct investment income that had been received but not yet allocated or distributed to shareholders. This account will be referred to as the Foreign Income account.

5. A record of tax paid or deemed to have been paid in respect of foreign income from direct investment, which was available for credit on distribution. This account will be referred to as the Foreign Tax account.

6. A record of surplus which had been allocated to shareholders or had accumulated prior to the effective date of the legislation or was otherwise available for distribution to the shareholders as a return of capital. This account will be referred to as the Non-Taxable Surplus account.

To provide an analysis of the financial surplus, it would be necessary to maintain these accounts. A record of "Reconciling Items" for other differences between the tax accounts and financial surplus might also be needed. Such differences could arise, as they do now, from claiming capital cost allowances which differed from the depreciation recorded in the financial statements or from revaluation of fixed assets.

The procedures in respect of foreign income would pertain only to those corporations which had direct investment abroad. The Foreign Income and Foreign Tax accounts would be used in a manner similar to the Taxed Income and Corporation Tax accounts, and accordingly will not be referred to specifically in the examples appearing later in this appendix.

Order of Distribution

The order in which distributions would be considered to come from these various accounts is also of concern. There would be some attraction in allowing discretion as to the order, and in most cases where all the corporate income had been fully taxed this could probably be done. However, where there were significant amounts of income from foreign direct investment or income untaxed as a result of incentive legislation that called for tax on distribution, reporting of distributions from these sources would tend to be unduly postponed, with a resulting deferment of tax.

A required order for determining the source of distributions would therefore seem necessary. The logical starting point would be income which had been fully taxed. Because distributions from this source would carry a claim on the government for the full corporation tax, this would be a natural

choice for the shareholder in any event. Where a corporation had income from foreign direct investment, the grossed-up amount of such income should be regarded as being distributed pro rata with the fully taxed income; this would not only seem logical, but would prevent postponement of the additional tax which might be payable on distribution of income from abroad. Further distributions of surplus should then be considered to come from income which was untaxed as a result of incentive legislation that called for tax on distribution; this would permit postponement of tax thereon as long as distributions of income with full credit were being made, but not when distributions were made by way of return of capital. Any further distributions would come out of non-taxable surplus and would be treated by resident shareholders as a return of capital and applied in reducing the cost basis of their shares.

In determining the order of distribution, the income of the corporation for the fiscal year in which the distribution was made probably should be taken into account. If this were done and if a corporation made a distribution which exceeded the total of its income for the year and all prior income which remained undistributed and unallocated, the exact division of the distribution as between the part which represented a distribution of income and the part which represented a return of capital would not be known until after the end of the year. This should not present a serious problem because the distribution would be made on the basis of an estimate and the exact breakdown for use by the shareholder in preparing his tax return would be reported to him after the end of the year. If the income of the corporation was subsequently varied by reason of re-assessment, then the corporation should be responsible for making the necessary adjustments at that time. There should not be an unduly large number of adjustments to the returns of shareholders because corporations would normally make distributions or allocations out of the Taxed Income account and this would not often be reduced on assessment. For purposes of administrative convenience it might be provided that minor changes in corporate income on re-assessment, not

exceeding a stipulated percentage of such income, say, 5 per cent, would not need to be reflected in amended returns of the shareholders but could be taken into account in the subsequent year in which the corporation's liability for tax was ultimately determined.

At the time of distribution the corporation would make any additional tax payments which might be necessary to enable the uniform rate of tax credit (equal to the rate applicable to corporate income) to be available to the resident shareholder. For example, such additional payments might be necessary for distributions or allocations out of untaxed incentive income or out of income from foreign direct investment.

Where a corporation received a taxable distribution or an allocation from another taxable Canadian corporation, it would include the grossed-up amount in its Taxed Income account, and the tax credit in its Corporation Tax account.

Reporting to the Shareholders

Because the integration of corporation and personal income taxes would apply only to resident shareholders, the changes in reporting would apply mainly to distributions or allocations to residents.

The form for reporting distributions or allocations to resident shareholders could contain five items:

1. The income before tax, that is, the "grossed-up amount" of the distribution.

2. The tax already paid or deemed to have been paid thereon.

3. The net amount of income represented by cash.

4. The amount of the distribution which was considered to be a return of capital and was to be applied to reduce the cost basis.

5. Where the distribution was a stock dividend or other capitalization of surplus, or where there was an allocation of surplus without a capitalization, the amount that was to be added to the cost basis.

With the uniform rate of tax credit, it would be possible for a corporation to issue only one reporting form each year, as is now done, although shareholders would wish to be informed currently of the details of any distribution or allocation involving an adjustment of cost basis so they could calculate the taxable gain on a sale of their shares. A form for annual reporting to shareholders is shown in the following illustration:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment

In practice, further details supporting the cost basis adjustment would be given on the form or in an attached letter.

For non-resident shareholders, the reporting would be much the same as at present because actual or deemed distributions would continue to be subject to withholding tax. The reporting form for non-residents could therefore be as follows:

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution

This form would be used for a cash dividend, a stock dividend or any other capitalization of surplus. It obviously would be necessary for a cash dividend to be paid in addition to any stock dividend or other capitalization

in order that the non-resident tax could be withheld. An allocation of surplus to shareholders without a capitalization would not need to be reported to non-resident shareholders, because its purpose would be solely to enable the portion of corporate income accruing to resident shareholders to be taxed at the appropriate rates of those shareholders. However, non-resident withholding tax would apply to any subsequent distribution or capitalization of such allocated surplus.

ILLUSTRATIONS

Presumably, the bulk of corporate distributions would be derived from business income taxed at regular corporate rates. Distributions in cash would no doubt continue to be important, but distributions by way of stock dividend or other capitalization of surplus and allocations of surplus without its capitalization could be expected to come into wide use. The following illustrations deal first with ordinary business income distributed or allocated in these various ways, and then with modifications which would be required for special features. A 15 per cent rate of non-resident withholding tax is used in the examples.

Ordinary Business Income Taxed at Regular Corporate Rate

Cash Distribution. If a corporation earned taxable income of $500, paid corporation tax thereon of $250, and then paid a cash dividend of $200, the entries in its tax and surplus accounts would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$500	$250		$250
Cash Dividend	(400)	(200)		(200)
Balances	$100	$ 50		$ 50

The dividend would be reported to shareholders as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$400	$200		$200

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$200	$30	$170

Stock Dividend or Other Capitalization of Surplus. If the distribution was by way of stock dividend or other capitalization of surplus, the entries in the corporation's tax and surplus accounts would be the same.

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$500	$250		$250
Stock Dividend	(400)	(200)		(200)
Balances	$100	$ 50		$ 50

The only difference in the corporation's accounts would be an increase in the capital instead of a decrease in cash. Management could supplement the reporting form with details of the capitalization, including instructions to resident shareholders concerning the cost basis adjustment. For a stock dividend, the increase in cost basis would be assigned to the new shares issued, unless the stock dividend was in the same class of shares, in which case the increased cost basis would be spread over the increased number of shares of that class. For a capitalization without a stock dividend, the increase in cost basis would be spread over the existing number of shares of the particular class. The distribution would be reported to resident shareholders as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$400	$200	+ $200	

As was indicated earlier, where there were non-resident shareholders it would be necessary that a cash dividend accompany any stock dividend or other capitalization, so that tax might be withheld from the non-residents. If the stock dividend or other capitalization referred to above was accompanied by a cash dividend of $40 to all shareholders, the distribution would be reported to non-residents as follows:

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$240	$36	$204

The net distribution to non-residents, assuming a 15 per cent non-resident withholding tax, would include $4 in cash.

Allocation of Surplus Without Capitalization. If there was an allocation of surplus without capitalization, the corporation's tax accounts would reflect the allocation but there would be no change in the financial surplus.

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$500	$250		$250
Allocation	(400)	(200)	$200	-
Balances	$100	$ 50	$200	$250

The corporation's records would reflect a transfer of $200 from ordinary surplus to Non-Taxable Surplus instead of a decrease in cash of that amount.

Resident shareholders would be instructed in the reporting form to increase the cost basis of their shares by the net amount of the allocation. For tax purposes, a portion of the corporation's surplus would thus be allocated to the shareholders, and when they subsequently realized upon it by selling their shares it would not be taxed again. If realization of this amount took the form of a cash distribution out of the Non-Taxable Surplus, the cost basis of shares would of course be correspondingly reduced.

The allocation would be reported to resident shareholders as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$400	$200	+ $200	

Here again management would presumably wish to supplement the reporting form with an explanation of what had occurred. There would be no reporting to non-resident shareholders because the allocation of surplus for tax purposes would only relate to resident shareholders. It should be noted, however, that in the corporation's tax accounts the amount deducted from the Taxed Income and Corporation Tax accounts in respect of the allocation would be the full amount allocated including the amount allocated to shares held by non-residents. If this was not done, then the corporation tax on income accruing to non-residents could be refunded to residents on a subsequent allocation.

Distributions Out of Opening Surplus
and Other Differences Between
Financial and Tax Surplus

The financial surplus of a corporation will frequently exceed the amount in the Taxed Income account. The difference would include the surplus existing at the time of implementation of the proposed system. It would also include amounts allocated but not distributed to the shareholders. In

addition, differences may result because the income shown in the corporation's accounts differs from the income as determined for tax purposes.

We have recommended that distributions in excess of the balance in the Taxed Income account should be treated as a return of capital and applied to reduce the cost basis of the shares owned by resident shareholders. Assuming that a corporation with no amount outstanding in its Taxed Income account makes a distribution of $5,000 out of its financial surplus, there would be no entries in the corporation's tax accounts but only a reduction of cash in the amount of $5,000 and a similar reduction in financial surplus. The reporting to shareholders would be as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
-	-	- $5,000	$5,000

Assuming that the distribution was by way of dividend or under a procedure which would result in a deemed dividend, the reporting to non-resident shareholders would be the same as under the present law and would be as follows:

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$5,000	$750	$4,250

Accelerated Capital Cost Allowances

As is indicated in Chapter 22, the regular capital cost allowances for tax purposes are often in excess of the depreciation considered necessary for financial reporting, and it is therefore common for financial surplus as recorded in the accounts to be greater than the surplus measured by tax rules. Furthermore, special acceleration of the capital cost allowances may

be considered an appropriate type of tax incentive in some circumstances. Examples are the recommended incentive for new and small businesses and the accelerated write-offs for the mining and petroleum industries, as well as the accelerated write-offs which are now allowed in designated areas. The system for integrating corporation and personal income taxes must therefore be designed to deal with distributions out of financial surplus which represent the excess of the total capital cost allowances taken, including accelerated capital cost allowances, over the maximum capital cost allowances which could have been taken on the normal basis.

One possible approach would be to regard distributions from this financial surplus as advance distributions of income, to be subjected to the regular corporation tax rate upon distribution.

To do this would appear on one hand to be a reversal of the rules established for the measurement of business income. On the other hand, it can be argued that the purpose of the incentive was to provide additional funds to the corporation and once the corporation was in a position to distribute these funds then it would only be reasonable to "recapture" the reduction in tax resulting from the incentive. In addition,there would be some advantage to taxing a "distribution" at the time the shareholder received the cash from which the tax would be paid. However, this recapture could not be applied to accelerated capital cost allowances that were equally available to unincorporated businesses. Moreover since it would not be practical to subject such unincorporated businesses to equivalent treatment, to do so in the case of corporations would be to treat different kinds of business organization differently for tax purposes. A major goal of the integration proposal is to provide neutral tax treatment between different kinds of business organization to the fullest extent practicable.

Another approach would be to regard a distribution from this source as being a partial realization of the cost basis of the shares, since it would be made out of surplus which did not yet exist for tax purposes. We prefer this latter approach and it is illustrated below.

In due course the capital cost allowances for tax purposes would become less than the normal capital cost which could have been taken if there had been no accelerated depreciation, and the surplus for tax purposes would come closer to that for financial purposes. For resident shareholders the applicable personal tax would not be payable until accumulated book allowances became equal to accumulated tax allowances or until the shareholders disposed of their shares. Non-resident withholding tax would be payable on any distributions to non-residents, but the applicable corporation income tax would not be payable until accumulated book allowances became equal to accumulated tax allowances.

Assume that in one year a corporation, after claiming capital cost allowances, had income for tax purposes of $8,000, but that if it had claimed only the maximum normal capital cost allowances its income would have been $15,000. Assume that a cash dividend of $6,000 was then paid. As only $4,000 was available for payment out of taxed income, the remaining $2,000 would be regarded as a return of capital. The entries in the corporation's tax accounts would be:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Taxable Income	$8,000	$4,000	$7,000	$11,000
Cash Dividend	(8,000)	(4,000)	(2,000)	(6,000)
Balances	-	-	$5,000	$ 5,000

Note that, as we indicated earlier, the distribution would be deemed to have been made out of taxed income first. The reporting to shareholders would be as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$8,000	$4,000	- $2,000	$6,000

Non-Resident Shareholder		
Gross Distribution	Withholding Tax	Net Distribution
$6,000	$900	$5,100

If the distribution of financial surplus arising from accelerated capital cost allowances was in the form of a stock dividend or other capitalization of surplus, the entries in the corporation's tax accounts would be unchanged. The reporting to resident shareholders would no longer show a net realization of the cost basis of shares, since the additional $2,000 would be a capitalization of surplus not yet measured for tax purposes:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
$8,000	$4,000	+ $4,000	

For a stock dividend in the same class of shares, the increased cost basis would have to be spread over the greater number of shares of that class. For a stock dividend in a different class of shares, a cost basis equal to $6,000 would be assigned to the shares issued and $2,000 would be deducted from the cost basis of the shares on which the dividend was declared.

A non-resident shareholder would still be subject to withholding tax on the full amount of the stock dividend or capitalization (assuming that the corporation had undistributed income on hand of at least that amount), since the amount capitalized could eventually be realized by the non-resident without withholding tax. Again a portion of the distribution would have to be in cash in order to provide for the withholding tax. The reporting to the non-resident shareholder would be the same as in the case of a cash dividend.

Incentives Other Than Accelerated
Capital Cost Allowances

It is emphasized in this Report that tax incentives are not usually the most appropriate means of attaining a desired goal and that they should be used infrequently. One type of tax incentive that might be used is the acceleration of capital cost allowances, which has already been illustrated. Under certain circumstances the government might consider that the postponement of income tax provided by the acceleration of capital cost allowances was not sufficient and that a greater incentive was required. We have suggested that an investment tax credit would be one of the best types of incentive for this purpose; a subsidy which did not depend for its effect on the offsetting of a tax liability would be another possibility.

The funds provided by an investment tax credit would ordinarily be related to a tax liability and would produce a saving in tax, thereby improving the yield from an investment. Under the proposed corporation tax system, a useful procedure would be to provide that a particular type or amount of income was not subject to corporation income tax, but that corporation income tax would be deemed to have been paid thereon. It could also be provided that upon distribution to the shareholders of the amount deemed to have been paid as corporation income tax, the corporation would be subject to tax on that amount. The effect would be the same as if the corporation tax had been paid and a subsidy received for the same amount, with a provision that on distribution of the subsidy to the shareholders, corporation tax would be payable thereon.

For example, assume a total investment tax credit of 10 per cent of $500,000, or $50,000, available for offsetting the annual corporation

income tax liability until the income resulting from the saving in tax was distributed. Assume also that the corporation earned income of $100,000, was deemed to have paid corporation tax of $50,000 and subsequently paid cash dividends of $50,000 and $25,000. The corporation's tax accounts would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$100,000	$50,000	$50,000	$100,000
Cash dividends:				
1. $50,000	($100,000)	($50,000)		($50,000)
2. $25,000			($50,000)	($50,000)
Balances	-	-	-	-

The first cash dividend, which would represent a full distribution of the regular income of $100,000, would carry a tax credit for $50,000 even though no tax was paid. The additional asset of $50,000 created by the investment tax credit has been treated in this example as income which upon distribution would be subject to 50 per cent corporation income tax and reported as income of the shareholder. The cash dividend from this source would be therefore only one half of $50,000, with the other $25,000 being paid in tax by the corporation at the time of distribution.

The reporting to shareholders would be as follows:

Resident Shareholder			
Report as Income	Claim as Tax Credit	Change Cost Basis (+ or -)	Cash Payment
1. $100,000	$50,000		$50,000
2. $ 50,000	$25,000		$25,000

Non-Resident Shareholder		
Gross Distribution	Tax Withheld	Net Distribution
1. $50,000	$7,500	$42,500
2. $25,000	$3,750	$21,250

It will be noted that the following effects would be achieved by this special tax measure:

1. The corporation would have been able to maintain a full distribution of its regular income with ordinary tax credits to shareholders and yet its tax payment to the government would have been reduced by $50,000, thereby supplying it with more funds.

2. When the corporation later distributed the corporation income tax saving to shareholders, the net return to the resident shareholders would increase by the amount of that saving less their respective tax rates. From $100,000 of corporation income, a resident shareholder in the 50 per cent bracket would have an after-tax yield of $75,000 rather than $50,000, and a shareholder in the 20 per cent bracket would have an after-tax yield of $120,000 rather than $80,000.

A stock dividend or other capitalization of surplus from the Incentive Income account would call for the same modifications in accounting and reporting procedures. However, it should be noted that, to the extent that

capitalizations were made from this source, there would have to be a cash payment on account of corporation tax equal to one half of the amount capitalized. In addition, a cash dividend might have to be declared to provide for non-resident withholding tax. An allocation of surplus would not likely be made from this source, because the corporation would be subject to a tax at the corporate rate on making the allocation.

There are other possible procedures for dealing with an investment tax credit or a subsidy. For example, it might be provided that the corporation tax saving or subsidy could be distributed to the shareholders free of tax, without adjustment of the cost basis of their shares or with a reduction in the cost basis equal to all or part of the amount distributed. The latter method would permit postponement of tax on a resident shareholder until his shares were disposed of, and would result in complete freedom from tax, both corporation and withholding, on the income for non-residents.

There are many other possible measures which could be adopted for incentive purposes, and further variations in the procedures for dealing with them. From the discussion above it should be evident that they could all be incorporated into the proposed integration of corporation and personal income taxes. However, it is our view that incentive measures should be used with care, for otherwise they may create undue reduction or postponement of taxes, and may lead to a complexity of rules which would make them difficult to administer and to understand.

Investment Tax Debits

An additional tax to discourage capital investment could take the form of a special excise tax on defined capital investment. Such a tax would represent merely an additional cost of investment, and no modification in the ordinary procedures for integrating corporation and personal income taxes would be required.

Business Losses

The general recommendation in the Report is that losses should be available for carry-back against any income for the previous two years and for carry-forward indefinitely against any income in future years.

Under the proposal for integration of corporation and personal income taxes, it would be important to ensure that the loss carry-back could not result in a refund to the corporation of taxes which had already been credited to the shareholders. Control over this would be exercised by using the Taxed Income and Corporation Tax accounts. The suggested rule would be that the loss carry-back would be limited to the lesser of (a) the total of the additions to Taxed Income account in the previous two years, or (b) the balance in the Taxed Income account at the time the loss carry-back was claimed. A refund of the corresponding corporation tax could then be made to the corporation. Any portion of the loss not carried back would be applied against income in the future, and no further corporation tax would be paid until it was fully absorbed.

Year	Item		Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
1	Income of	$2,000	$2,000	$1,000		$1,000
2	Income of	$3,000	3,000	1,500		1,500
	Dividend of	$2,000	(4,000)	(2,000)		(2,000)
3	Loss of	$3,000	(1,000)	(500)	($2,000)	(2,500)
4	Income of	$6,000	4,000	2,000	$2,000	4,000
Balances			$4,000	$2,000	-	$2,000

Note that the loss carry-back would be allowed only to the extent of $1,000 and would result in a tax refund of only $500, because the rest of the tax for the previous two years would already have been allowed as a credit to shareholders who received the dividend in year 2. The remainder

of the loss ($2,000) would be carried forward and this would result in no corporation tax being charged on that amount of the income of year 4.

Disallowed Expenses

No distinction would have to be made between unallocated personal benefits and disallowed expenses of the business. The former would be deductible in arriving at business income under our proposals, but would be grossed-up at the top personal rate and would be subject to a special tax in the hands of the corporation rather than in the hands of the recipient. This special corporation income tax would be deductible in determining the corporation's taxable income. This is explained in Chapter 14. The end result would be that taxes paid would be the same as would have applied had the person receiving the benefit received the income necessary to acquire it out of income taxed at the top personal rate. Disallowed expenses could be treated in the same manner, since under our proposals all expenses relating to the income earning process would be deductible at some time, and, generally speaking, the only disallowed expenses would be those which were unreasonable or were unrelated to the earning of income.

To illustrate the treatment of unidentified personal benefits and disallowed expenses, assume that a corporation had business income of $20,000 and that the expenses deducted in arriving at this income included $2,000 of such benefits or expenses. The corporation would pay a special tax of $2,000, that is, 50 per cent of the benefits or expenses grossed-up to $4,000. The tax of $2,000 would then be allowed as a deduction, and this would reduce the corporate income to $18,000. In the tax accounts of the corporation, the entries would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Income	$18,000	$9,000		$9,000

A shareholder in the top personal rate bracket would then net $9,000 on a distribution of the entire surplus, so that he would be in the same position as if he had received a distribution of surplus arising from business income of $22,000, had paid $11,000 tax thereon and had paid $2,000 from his tax-paid income to acquire a personal benefit.

Changes in Corporation Tax Rate

As explained in the Report, the corporation income tax rate and the top marginal personal rate should remain the same or virtually the same under the proposed integration method. Furthermore, any changes in these rates should be infrequent and not substantial. For resident shareholders, the level of the corporation tax rate would lose much of its significance because the corporation tax would be in effect a withholding tax. However, for non-resident shareholders the level of the corporate rate would retain its present significance.

When changes in the corporation tax rate took place, some variation in the procedures outlined above would have to be made if the gross-up and credit was to be at all times directly related to the current statutory rate of corporation tax. For example, if there was an increase in the corporation income tax rate and the top marginal personal rate remained unchanged, one possible procedure would be to withhold extra tax on distributions from income taxed at the former corporate rate in order to maintain a uniform rate of tax credit for residents. However, this would constitute retroactive taxation for non-residents, and to avoid such retroactivity by withholding the extra tax from distributions to residents only, would add an administrative complexity.

A practical approach would be to use the Corporation Tax account as a control on the total of past taxes available for credit, and adjust the Taxed Income account to reflect the new rate of corporation tax, which would be the rate at which tax credits would be issued. Assume, for example, that

at a time when the corporate rate increased from 50 per cent to 55 per cent, a corporation had on hand surplus of $200 resulting from income of $400 taxed at 50 per cent. Its tax accounting could then be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Balance on hand	$400	$200		$200
Balance adjusted to 55 per cent rate	$364	$200	$36	$200
Balances	$ 36	-	$36	-

For resident shareholders, this would mean that $164 could be distributed carrying a 55 per cent credit, and that the balance of $36 would, upon distribution, be treated as a return of capital to be deducted from the cost basis of the shares and eventually taxable as a gain on disposal of the shares. For non-residents, all distributions would be subject to withholding tax as usual, and the increase in the corporate rate would have no retroactive effect.

Similarly, if the corporate rate should be reduced from 50 per cent to 45 per cent, the corporation tax accounting would be as follows:

Item	Taxed Income	Corporation Tax	Other Accounts	Financial Surplus
Balance on hand	$400	$200		$200
Balance adjusted to 45 per cent rate	$364	$164		$200
Balances	$36	$ 36		-

In this case both the Taxed Income and Corporation Tax accounts would be adjusted, so that the net amount would not exceed the surplus on hand. As a result the income to be reported by the shareholder upon distribution would be reduced by $36, and corporation tax available to the shareholder as a

credit would be reduced by the same amount. While it might be thought that the Corporation Tax account should remain at $200 and the Taxed Income account should be grossed-up on the basis of a 45 per cent rate to $444, this would permit the corporation to allocate a total of $244 to the shareholders and would permit them to increase the cost basis of their shares by that amount, even though the corporation had paid tax on only $200. Accordingly, the appropriate treatment would be that shown above, which would adjust both the Taxed Income account and the Corporation Tax account to amounts which, when the Corporation Tax account was grossed-up at the new rate, would leave the financial surplus unchanged.

REFERENCES

1/ The proposal calls for a tax credit to the shareholder who receives a distribution or allocation equal to the corporation tax applicable to the amount distributed or allocated. It also calls for a tax refund where the amount of the applicable corporation tax exceeds the total income tax payable by the shareholder. In this appendix we refer to the excess of the corporation tax over the shareholder's personal income tax on the distribution or allocation as a "refund", although in practice it would usually be applied against the liability of the shareholder for tax on his other income.

2/ The ratio to be applied to the distribution or allocation for determining the amount to be reported as income, which could be called the "grossing-up ratio", would be 100 divided by the difference between 100 and the percentage rate of tax credit. For example, if the rate of tax credit was 40 per cent and the amount of the distribution or allocation was $72, then the amount to be reported as income would be

$$\frac{100}{100-40} \times \$72 = \$120$$

3/ In Chapter 26 we recommend that in the case of income from foreign direct investment, a credit for foreign tax should be allowed at the rate of 30 per cent and that if the rate of foreign tax was less than this, sufficient additional Canadian tax should be payable to bring the rate up to 30 per cent.

4/ The likelihood of this occurring would be greater where there was a series of intercorporate shareholdings.

5/ On notes to the financial statements.

APPENDIX I

THE DUAL RATE OF CORPORATION INCOME TAX

One of the main features of the present taxation of corporate income is the existence of a dual rate of corporation tax. With certain exceptions to be discussed later in this appendix, corporations are presently subject to tax at the rate of 21 per cent (18 per cent normal corporation income tax plus 3 per cent imposed by the Old Age Security Act) on the first $35,000 of taxable income, and at 50 per cent (47 per cent normal corporation income tax plus 3 per cent imposed by the Old Age Security Act) on the remainder.

The dual rate was first introduced into the Canadian corporation tax structure in 1949. Its purpose was explained by the then Minister of Finance as follows:

> "At present we have a flat rate tax of 30 per cent on all corporate profits. I am recommending that this 30 per cent be reduced to 10 per cent on profits up to $10,000 and increased to 33 per cent on profits in excess of $10,000. The house will at once recognize this as tax relief for small businesses and will, I trust, be heartily in accord with the policy. Our country as a whole owes a great deal to the small family type of business. They have to struggle along, grow and develop in competition with large and well financed corporations whose activities may be nation-wide. My own belief is that small businesses should be encouraged and it seems to me that a useful way to do this is to lower the tax and take less out of the funds they need for growth and expansion." 1/

Since 1949, numerous changes have taken place in both the rates of corporation income tax and the amount of taxable income which is eligible for the low rate, the most recent being an increase to $35,000 in the eligible amount for 1961 and subsequent taxation years. In introducing this proposed change the Minister of Finance indicated that it was designed to aid small corporations to enlarge the scope of their operations, particularly those corporations which were not large enough to have ready access to the securities markets. He also stated that it would extend the benefit of the low rate of tax to an additional 4,000 corporations and that, out of approximately 62,000 corporate income taxpayers, 55,000 had incomes below $35,000 and would in future pay no more than 21 per cent 2/.

It would be an over-simplification to assume that the purpose and effect of the dual rate can be determined and its significance measured solely, or even primarily, by comparison of the lower rate of tax on corporate income below a certain level with the higher rate on corporate income above that level.

When the rate of 10 per cent on the first $10,000 of corporate income was instituted in 1949 there was introduced concurrently a 10 per cent dividend tax credit; and when the rate on the first part of corporate income was increased later to 21 per cent, the dividend tax credit was increased to 20 per cent. It is logical to infer that, on corporate income below a certain level, the intention was to integrate almost fully the corporation tax with the personal tax on distributed earnings.

Because encouragement was to be given "to the small family type of business", two further conclusions may be drawn:

1. The businesses to be encouraged were generally ones that, for practical purposes, need not be conducted in the corporate form.

2. Earnings retained in the business, as well as those distributed, generally could be integrated for tax purposes with personal rates by the fairly simple expedient of distribution and recommittal to the business.

Because small family type businesses generally can disincorporate if it is advantageous to do so, one result of the lower corporation tax rate coupled with the dividend tax credit was to make it unnecessary to do so for tax purposes.

ANALYSIS OF EFFECTS

We have examined the purpose and effect of the dual rate of corporation tax from a number of aspects which are discussed in the following sections of this appendix.

Applicability to Corporate
Business Only

The purpose of the dual rate, as evidenced by the previously quoted statement of the Minister of Finance, is to encourage the small family type business by taking less out of the funds they need for growth and expansion, but it is immediately apparent that a reduction in the rate of corporation tax as a means of achieving this intention can only be of benefit to businesses conducted in the corporate form.

It is not known what proportion of small businesses was conducted in the corporate form in 1949, but it has been estimated that in 1959 there were some 440,000 small businesses in Canada 3/. A "small business" in this estimate was a business with assets of under $1,000,000, and it was stated that most of such businesses were unincorporated, had assets of under $100,000 and were engaged in retail trade, services and construction. For the 1961 taxation year, there were 97,355 corporations with assets of less than $1,000,000, of which 62,104 earned a profit. For the same year there were 52,136 corporations with assets of less than $100,000, of which 29,980 earned a profit 4/.

On the basis of the previously quoted figures the maximum number 5/ of small corporate businesses which would benefit from the low rate would be 62,104 if assets of $1,000,000 were used as a criterion of "small", and 29,980 if assets of $100,000 were used. These represent approximately 14 per cent and 6.8 per cent of the estimated small businesses in Canada, assuming no material change in numbers since 1959. The remainder could obtain no benefit from the low rate of corporation tax because they made no profit or because they were unincorporated.

The low rate undoubtedly takes less of the funds of those corporations that can benefit from it, but its effect is limited to a comparatively small proportion of the small businesses in Canada.

However, it can be considered to discriminate against businesses conducted in unincorporated form, and it should be noted that it is available to corporations in respect of their investment income as well as their business income.

Availability to all Corporations

Subject to the restrictions placed on associated corporations to be dealt with later, the low rate of corporation tax is available to all corporations irrespective of size, need of financial assistance, and actual or potential growth. The Honourable D.C. Abbott acknowledged that size was in no way determinative when introducing the original legislation, but at the same time stated that the combined effect of the low rate of 10 per cent on the first $10,000 and the increase of 3 per cent in what had previously been the flat rate resulted in a decreased tax burden on those corporations whose profit was less than $77,000 and an increased burden on those with greater profits 6/. The change in total revenue from the taxation of corporations was negligible. It is interesting to note that, if a flat rate of tax had been introduced in 1961 which raised approximately the same revenue as the existing dual rate, corporations with profits of approximately $200,000 would have broken even. It would probably be unwise to conclude that the measure of a small corporation has changed from one with a profit of less than $77,000 in 1949 to one with a profit of less than $200,000 in 1961.

The maximum dollar benefit that can be obtained from the dual rate is $10,150, and this is available to all corporations with taxable income of $35,000 and up. As the amount of taxable income decreases below $35,000 the dollar benefit decreases proportionately. Expressed as a percentage of the tax that would be payable at a flat rate of 50 per cent, the benefit is 58 per cent for all corporations with taxable incomes of up to $35,000 and gradually decreases to 4 per cent at $500,000. No benefit accrues to the corporation that does not make a profit, though it might well be argued that such a corporation is in greater need of assistance.

By making the benefit available to all corporations and relating it to the amount of profit, the problem of defining small business is avoided but, as evidenced by the associated-corporation legislation, definitional problems are not eliminated. By making the benefit available to all corporations, its cost is greater than would be the case if the benefit were restricted to small corporations (however defined). In 1961, there were 7,374 corporations with taxable incomes in excess of $35,000. 7/ Not all of them would be entitled to the low rate of tax because of the rules respecting association, but, assuming that 6,500 are so entitled, the benefit to them costs in excess of $65,000,000, or rather more than one third of the total cost of the low rate. However, to avoid anomalies, a notch provision would be necessary if the low rate were to be withdrawn from corporations with profits in excess of $35,000.

Availability Irrespective of
Disposition of Profit

Since its introduction in 1949, the low rate of corporation tax has been a significant factor in assisting small corporate businesses to expand. This is so because such businesses have had the power to retain a greater portion of their profits for reinvestment. It is not mandatory, however, for the profits to be used for business expansion and, as a result, it is possible for corporations to use the increased profits for purposes unrelated to the business or to increase the amount of their distribution to shareholders. In these latter cases the reduction in corporation tax is not used in accordance with the underlying intention of the legislation.

For the 1961 taxation year there were 59,864 profitable corporations with incomes of less than $35,000. Their aggregate profits totalled $590.7 million which includes $82.7 million of Canadian dividends received. These corporations paid cash dividends of $131.9 million, or approximately 22 per cent of the aggregate profits.

Introduction of Progressiveness Into the Corporation Tax Structure

The dual rate introduces a degree of progressiveness into the corporation tax structure above the $35,000 level of corporate taxable income. The degree of progressiveness rises very sharply from $35,000 taxable income to about $100,000 and very gradually above $100,000. Table I-1 illustrates this feature.

TABLE I-1

PROGRESSIVENESS OF THE DUAL RATE OF CORPORATION TAX

Taxable Income ($)	Tax on First $35,000 ($)	Remaining Taxable Income ($)	Tax on Remainder ($)	Total Tax ($)	Effective Tax Rate (%)
1,000	210	-	-	210	.210
35,000	7,350	-	-	7,350	.210
50,000	7,350	15,000	7,500	14,850	.297
75,000	7,350	40,000	20,000	27,350	.365
100,000	7,350	65,000	39,850	44,850	.398
250,000	7,350	215,000	107,500	114,850	.459
500,000	7,350	465,000	232,500	239,850	.480
1,000,000	7,350	965,000	482,500	489,850	.490
5,000,000	7,350	4,965,000	2,482,500	2,489,850	.498

Equity

It was suggested above that the low rate discriminated against businesses conducted in unincorporated form, but it may also be said to discriminate against income derived from other sources. To the extent that the low rate is intended as an incentive to business growth and expansion this is inevitable, but earlier the low rate was criticized on the ground that it was

available even if all the profit was withdrawn. Table I-2 shows the effect of the low rate of corporation tax in certain selected circumstances.

TABLE I-2

COMPARISON OF THE TAXES PAYABLE
ON AN ADDITIONAL $100 OF INCOME

	When Earned by Corporation			
Marginal Personal Tax Rate	Corporation Tax Paid	Personal Tax Paid a/	Total Tax Paid	Unincorporated Business or Employee Remuneration
10	$ 21.00	$(7.90)	$ 13.10	$ 00.00
20	21.00	00.00	21.00	20.00
40	21.00	15.80	36.80	40.00
60	21.00	31.60	52.60	60.00
80	21.00	47.40	68.40	80.00

a/ This is the personal tax on the dividend received of $79.00 ($100.00 of corporate income less $21.00 corporation tax paid) less the dividend tax credit of $15.80 (20 per cent of $79.00). It is assumed that for taxpayers with a marginal personal tax rate of under 20 per cent the dividend tax credit can be fully utilized against tax on other income. Old age security tax is ignored in the application of the dividend tax credit.

The effect of the low rate of corporation tax combined with that of the dividend tax credit is to increase the total tax payable over what it would be at the personal rates when the shareholder's marginal rate is 20 per cent or lower and to decrease the total tax payable where the shareholder's marginal rate exceeds 20 per cent. At a marginal rate of 80 per cent the decrease in total taxes payable is $11.60 or 14.5 per cent.

Because in the ultimate analysis all corporations belong to individuals, any increase in the wealth of a corporation must affect the wealth of

individuals. The low rate of tax is available to corporations irrespective of the number of shareholders, and it follows that the fewer the shareholders the greater the benefit that accrues to each. For example, if a corporation is owned by one person, that person derives the full benefit of the low rate of tax up to a maximum of $10,150 a year, but for a similar corporation with ten equal shareholders the benefit to each shareholder would amount only to a maximum of $1,015 a year. To this extent also, the low rate produces very uneven consequences.

Complexity of the Law: Associated Corporations

When the dual rate of corporation tax was introduced in 1949, it was foreseen that the benefit (at that time a maximum of $2,300 per annum) to be obtained from the low rate might provide taxpayers with sufficient inducement to create new corporations or to divide existing corporations to increase the amount of income taxable at the low rate, and that preventive legislation would be required. Because the intent of the low rate was to encourage small businesses, it might have been anticipated that the anti-avoidance legislation would not be directed at corporations whose existence could be justified for sound business reasons, but only at those created for tax-reduction reasons. As enacted, however, the associated-corporation legislation provided that, where two or more corporations were related to each other in a taxation year, the income of those corporations should be aggregated for tax purposes so that only one low rate of tax would be available irrespective of the number of corporations involved. The rules for determining relationship were as follows:

> "...one corporation shall be deemed to be related to another in a taxation year if, at any time in the year, (a) it, directly or indirectly, controls the other, (b) it is, directly or indirectly, controlled by the other, or (c) both corporations are controlled, directly or indirectly by the same person." 8/

As a result of taxpayer complaints 9/ this test of relationship was repealed retroactively and was replaced by a test based on ownership of 70 per cent

or more of all the issued common shares of the capital stock of the relevant two or more corporations at any time in the year 10/. It is not necessary to analyze the supporting legislation to establish that the required percentage of ownership was the only test for denial of the low rate, even where the corporations were conducting entirely dissimilar business at opposite ends of the country. It can be said that the supporting legislation was complex and occasioned numerous judicial decisions particularly concerning the concepts of "direct or indirect ownership" and "arm's length". Despite the introduction of further complex legislation, the ingenuity of taxpayers was such that the intent of the legislation was being thwarted. In 1960, therefore, the legislation dealing with associated corporations was substantially amended. One of the major changes was that the 70 per cent ownership test was abandoned and replaced by the test of control. The legislation dealing with associated corporations up to 1963 was detailed, lengthy, complex and, in some areas, uncertain. Despite this, the intent of the legislation was still being circumvented.

This struggle between the taxpayer and the Revenue culminated in the enactment in 1963 of section 138A(2) of the Income Tax Act which reads as follows:

> "(2) Where, in the case of two or more corporations, the Minister is satisfied
> (a) that the separate existence of those corporations in a taxation year is not solely for the purpose of carrying out the business of those corporations in the most effective manner, and
> (b) that one of the main reasons for such separate existence in the year is to reduce the amount of taxes that would otherwise be payable under this Act
> the two or more corporations shall, if the Minister so directs, be deemed to be associated with each other in the year."

This section is noteworthy in that it introduces an element of ministerial discretion and formulates the dual test of business purpose and tax reduction purpose. However, it should not be assumed that the formulation of the new tests represents a change in policy toward eligibility for the low rate. It merely represents an additional hurdle to be surmounted by the

taxpayer when he has first passed the test of control imposed by section 39 of the Income Tax Act. The introduction of this type of legislation carries with it the admission that detailed legislation spelling out the circumstances in which the benefit from more than one low rate allowance will be denied has not been successful.

The taxpayer has the right to appeal a direction under section 138A(2), but in deciding whether to vacate the direction it is provided that the Tax Appeal Board or the Exchequer Court may only do so if it has determined that "...none of the main reasons...is to reduce the amount of tax..." otherwise payable. The appeal provision contains no reference to the extent, if any, to which the appropriate forum may consider whether the separate corporate existence is explicable on the ground that it most effectively carries out the business of the corporations.

In summary, the legislation, as it presently exists, permits only one allowance of taxable income at the low rate of tax to a group of corporations that are under common control or whose separate existence is not solely for the purpose of carrying out their business in the most effective manner and when one of the main reasons for such separate existence is to reduce taxes. The former of these two tests of association is contained in complex, lengthy and, in some parts, obscure technical legislation.

There is, as yet, no indication as to the manner in which section 138A(2) will be applied, but there seems to be an implied dual standard for eligibility for more than one low rate allowance. Thus, where the degree of control of the various corporations falls within the technical rules of section 39 and supporting legislation it is automatic that only one low rate allowance will be granted. But where the taxpayers have been sufficiently fortunate or sophisticated to escape these technical rules (but presumably not the intent), the test for denial of more than one low rate allowance will be lack of business purpose and presence of tax reduction intention.

The presence of the dual standard referred to in the preceding paragraph has led us to consider whether a better standard could be introduced. Because it may be impossible to draft specific detailed legislation in such a way as to eliminate all presently known means of avoiding association, let alone new methods which will probably be devised, we considered whether the basis for denial of the low rate to a corporation could be encompassed in a general statement leaving the interpretation of particular cases to the courts. For example, the tests embodied in section 138A(2), with ministerial discretion removed, might be enacted as the sole tests for denial of the low rate to a corporation. This might appear to conform more closely to the original intent of providing assistance to small businesses because no consideration would be given to who the shareholders of these businesses are in determining eligibility for the low rate.

In considering the possibility of recommending a radical change such as that described in the preceding paragraph one is faced with the difficult task of attempting to evaluate the unknown. Among the questions that flow out of a consideration of such a proposal and to which definitive answers are clearly not available, are the following. Would the introduction of such subjective tests of business and tax reduction purposes lead to excessive litigation? Do these tests lack the desired level of certainty? Would the Department of National Revenue be placed in a very difficult position if, on appeal and notwithstanding the deemed correctness of an assessment, the Department was required to adduce evidence to discharge the burden of proof that might be shifted to it? While these questions cannot be decided in the absence of the experience that would be gleaned over years of actual implementation, it must be remembered that the scheme currently in effect is not perfect. Consequently, any defects that might arise in any contemplated new legislation, such as those alluded to in the questions previously posed, would not necessarily represent a deterioration from the status quo. Indeed, the existing legislation has produced a substantial amount of litigation and it is doubtful that it can be held out as a good example of the desirable

level of certainty. On the other hand, it is believed that while the subjective elements in the contemplated proposal might tend to weaken the position of the Department in any instance where the onus of proof was shifted to it, the Department manages to administer and enforce other sections of the Act in which similar problems arise such as, for example, where reasonableness is an issue.

In view of these previously discussed uncertainties and in an attempt to maintain an acceptable level of administrative and enforcement facility, some variation of the business and tax reduction purposes test, possibly less liable to taxpayer abuse, could be substituted. This could provide that, where common ownership was in excess of a certain percentage, only one allowance of income taxable at the low rate was available, and where common ownership fell below the prohibited percentage but still provided control, the business and tax reduction purposes test would come into play with the onus of proof being shifted to the taxpayer. Such a modification would be, in principle, somewhat similar to the present position. The percentage level at which the automatic denial of the low rate would be established would be conditioned by the desire to reduce litigation, to increase certainty, and to balance the relative strengths of the taxpayer and the fisc. Because some of these considerations work in opposite directions, the decision as to the appropriate percentages would not be one of principle but of pragmatic judgment.

The dual rate of corporation tax is largely responsible for the existence of the associated-corporation legislation, but in the years since its introduction other incentive legislation has made use of the same associated-corporation rules. The elimination of the dual rate would remove the major need for the associated-corporation rules, and, if other tests to prevent abuse of incentive legislation were devised, the retention of associated-corporation rules would be unnecessary.

As a Barrier to Tax Reform

The low rate of corporation tax may well act as a barrier to the reform of the present system of taxation. Many suggested changes to the present tax structure could not be implemented, or would be rendered excessively complicated, if the low rate of corporation tax was to continue at its present level. Thus, further integration of the corporation tax with the personal tax rate structure would be difficult with the low rate at the present level, and some of the proposals made to eliminate surplus-stripping would be emasculated.

EFFECTS OF WITHDRAWAL OF THE LOW RATE OF CORPORATION INCOME TAX

As a result of our examination of the effects of the dual rate of corporation income tax, we concluded that, although it permitted certain small businesses to retain funds which could be used for expansion and growth, it seemed to be a relatively inefficient method of doing so. Although any form of incentive legislation directed at special sectors of the economy results in anomalies and inequities, the low rate of corporation income tax applies to all forms of corporate business activity and its consequences are, therefore, more widespread than other incentives. For these reasons and because its continuation inhibits tax reform, we considered the effects of its withdrawal.

In broad terms, the abolition of the lower rate would increase tax revenues from the corporate sector by approximately $185 million. If this amount was applied to the reduction of corporation income tax it would be possible to levy a single rate of corporation income tax of somewhat less than 45 per cent. However, this broad approach does not demonstrate the impact that the withdrawal would have on corporations of different income classes. The maximum increase in the tax burden to any one corporation would be $10,150 if the single rate was maintained at 50 per cent, or $8,400 if the single rate was 45 per cent, but the following table showing

the effect at various levels of corporate income illustrates the results with greater clarity.

It will be observed from Table I-3 that for corporations with taxable incomes up to $35,000 the tax burden is more than doubled whether the single rate of corporation tax is set at 45 per cent or 50 per cent. This would reduce the present after-tax income of these corporations by 36.7 per cent, at a 50 per cent corporation income tax rate, and 30.4 per cent, at a 45 per cent corporation income tax rate.

It will also be observed that, at a 45 per cent corporation income tax rate, there is little difference in the tax burden of corporations with taxable incomes of $200,000, and that for corporations with incomes in excess of that figure there is a reduction in the tax burden.

We do not believe that the withdrawal of the low rate of corporation income tax would have any serious effect on corporations with incomes in excess of $100,000, particularly if the single rate was set at approximately 45 per cent, but these companies numbered only 2,907 out of a total of 67,238 companies which earned a profit in the 1961 taxation year.

For corporations with incomes of less than $100,000, it is probable that a sudden increase in the tax burden of the magnitude indicated by Table I-3 would have serious results. For example, many of these corporations have indebtedness, and the agreed conditions of repayment may well have been computed on the basis of cash flows predicated on continuation of the low rate of corporation tax. It is true that tax rates are never constant and are subject to continual change, but seldom are changes of this order made, except in times of national stress, and even then the impact is not confined to one specific sector of the economy. In addition, there are certain economic considerations which are discussed in Chapter 22.

Thus, the removal of the dual rate, without some compensating provision for new and small businesses, would not appear to be a reasonable proposition.

TABLE I-3

COMPARISON, AT VARIOUS LEVELS OF CORPORATE INCOME, OF THE PRESENT CANADIAN TAX BURDEN WITH THAT UNDER A SINGLE CORPORATION TAX RATE OF 50 PER CENT AND 45 PER CENT

Corporate Income Level	Present Canadian Tax Burden	Flat-Rate Tax At 50 Per Cent	Increase (3) Over (2)	Flat-Rate Tax At 45 Per Cent	Increase (Decrease) (5) Over (2)
(1)	(2)	(3)	(4)	(5)	(6)
$ 5,000	$ 1,050	$ 2,500	$ 1,450	$ 2,250	$ 1,200
10,000	2,100	5,000	2,900	4,500	2,400
20,000	4,200	10,000	5,800	9,000	4,800
30,000	6,300	15,000	8,700	13,500	7,200
35,000	7,350	17,500	10,150	15,750	8,400
75,000	27,350	37,500	10,150	33,750	6,400
100,000	39,850	50,000	10,150	45,000	5,150
200,000	89,850	100,000	10,150	90,000	150
1,000,000	489,850	500,000	10,150	450,000	(39,850)
5,000,000	2,489,850	2,500,000	10,150	2,250,000	(239,850)

Note: In the case of corporations whose shareholders are either employees or directors the increase in tax can in many cases be reduced by payment of increased salaries or fees. Assuming that the optimum salaries or fees are presently being paid, the final result will be an increase in overall tax but less severe than indicated in the above table.

ALTERNATIVES TO THE DUAL RATE OF CORPORATION TAX

Because of criticisms of the dual rate of corporation tax discussed above, and because its sudden withdrawal could cause considerable hardship to many small corporations, we examined a number of alternative methods within the tax structure of easing the burden on low income corporations.

Option to Elect to be Taxed as a Partnership

To mitigate the increased tax burden on small corporations, an option could be extended to the shareholders to elect to be taxed in the manner in which a partnership is presently taxed. To prevent abuse, to make it administratively feasible, and to prevent loss of revenue from the non-resident sector such an option would have to be conditional. Thus, there would have to be a restriction on the number of shareholders, the shareholders of the electing corporation would have to be individuals resident in Canada, there would have to be restrictions in the case of a complex capital structure and the election would have to be consented to by the holders of most of the shares. It might also be necessary to withhold the right of election where shares are transferred during the corporation's fiscal year, or at least establish special rules to deal with such transfers. An option which is subject to restrictions along these lines is recommended in Chapter 19.

This proposal has certain advantages. It can be justified on the premise that the form in which a business is conducted should not be unduly influenced by tax considerations. Such an option would also permit corporate losses to be "passed through" to the shareholders. This may be of particular value in the early years of the life of a business.

However, corporations whose shareholders are all employees or possibly directors effectively have this option available to them now in their ability

to fix levels of remuneration. However, it would be of advantage to small corporations where the shareholders are not employees. In most cases the net result of this option would be an increase in the overall tax burden but not as severe as that indicated in Table I-3.

The partnership option does not by itself appear to provide a sufficient amelioration of the serious results of complete withdrawal of the low rate of corporation tax.

Deferment of Payment
of Income Tax

The rationale of this suggestion is that the main reason for assistance to small businesses is to compensate them for their inability to raise capital to assist in their expansion. In its simplest form, it would tax all corporations at a flat rate of tax but, except for associated corporations, the payment of that portion of the tax representing the difference between the present low rate and the flat rate could be deferred subject to payment of a moderate rate of interest. The total amount of tax which could be deferred could be limited to the lesser of, say, $50,000, or the amount of the shareholders' equity, and would be subject to immediate payment on winding up, on ceasing to carry on an active business, or on becoming non-resident. It should be observed that the amount deferred would at all times be a liability of the corporation. It is possible, of course, to add further qualifications to such a proposal, but each additional qualification is likely to result in more complex legislation and further anomalies.

Because the deferred tax payment would be a liability of the corporation, it would result in a reduction in the surplus available for dividends and should influence retention of the funds within the business. It would also substitute indefinite deferment of a limited amount of corporation tax liability for what might currently be regarded as a remission of an amount of corporation tax that is subject to an annual limitation only. In effect, it would withdraw the benefit of the low rate of tax and would substitute a $50,000 maximum loan of indefinite duration.

It would moderate the effect on the cash flow of small profit corporations because the lower the profit the longer it would take to reach the maximum amount of deferment. For a corporation with a taxable income of $5,000 per annum the limit on deferment of $50,000 would not be reached for over 30 years. For corporations with taxable incomes of $35,000 and up the maximum limit would be reached in 5 years.

It is subject to many of the criticisms levelled at the dual rate of corporation tax. In particular, the necessity of associated-corporation legislation would remain, it would be available only to corporations, it would not assist unprofitable corporations, and to a more limited extent it would discriminate against other forms of income.

The existence of the deferred tax liability, particularly if it had priority over other claims in bankruptcy, may have adverse effects on the ability of small businesses to arrange other financing.

The suggested limit on the amount of tax deferment might be insufficient to avoid some hardship to those corporations that had geared repayment of long-term debt to a cash flow computed on the basis of the continued existence of the low rate of corporation tax.

Because the reduction in tax payments would be subject to a limit, it would be available for a variable but limited period. To this extent, it may be considered an aid to new corporations rather than small profit corporations.

The Creation of an Investment Reserve

In its most generous form, this proposal envisages that corporations should be permitted to build non-taxable reserves to a maximum amount at an annual rate which would result in the same reduction in tax payable as does the present low rate. If the amount of the reserve was not used within a prescribed period for new investment in plant, equipment, mineral exploration,

export promotion, or other approved expenditure it would be brought back into the corporation's income and taxed accordingly.

In essence, this plan would permit the corporation to provide for expenditures before they were incurred, and it carries with it the implication of approval of the appropriate expenditure by the tax authorities.

It is subject to many of the same criticisms that have been raised against the dual rate and introduces some further administrative complexities and problems.

Free Depreciation Policy

This proposal, which would be available to corporations with an upper income limit, would result in a deferment of income tax and would relate the benefit to retention of funds within the business. The free depreciation policy proposal has a bias in favour of "depreciable asset" intensive industries, but as discussed in Chapter 22 it is in this area that a capital market bias may exist. The associated-corporation problem would remain. However, it would be possible to extend the benefit of these proposals to unincorporated businesses. In order to avoid inequality of tax circumstances between businesses just above and those just below the upper income limit for eligibility, it might be desirable to have a notch provision.

Increased Personal Tax Credit

Another method of mitigating the effects of eliminating, or of increasing, the low rate of tax would be to increase the present dividend tax credit. Although the effect of an increase in the low rate of tax would be to impose an additional burden of taxation on the corporation, this would be compensated to some extent by an increase in the dividend tax credit available to shareholders on distribution. It would be essential that the dividend tax credit be made available for refund to the individual shareholder if its benefit was not to be denied to the shareholder whose need was greatest, that is, the

comparatively low income shareholder of the low income corporation.

The total personal and corporation income tax burden imposed on corporate income could be held at the approximate personal tax liability of its shareholders on an equivalent amount of income, provided the corporate income was distributed. It is true that, to achieve this result, the income must be distributed and this may be considered to defeat the purpose of the low rate particularly if the income was not reinvested in the corporation. However, if the assistance was directed at the family-owned small business, then the closer the identification of the shareholders with the business the more likely that reinvestment in the business would follow if the funds were required for expansion and growth.

To the extent that it resulted in an increase in the lower rate of corporation tax, it would permit greater flexibility in the area of tax reform but an increase in the dividend tax credit, as discussed in Chapter 19 and Appendix F to this Volume, would reduce the degree of progressiveness of personal tax in respect of corporate distributions.

CONCLUSIONS

1. The low rate of corporation tax gives small profitable corporate businesses the power to retain a greater portion of their profits for reinvestment in the business and, to this extent, can be a significant factor in their ability to expand.

2. The dual rate of corporation tax is an imperfect means of providing assistance to small business because:

   a) It is inefficient in that it is available only to a minor segment of the small business community, that is, profitable businesses conducted in the corporate form.

   b) It is available whether or not the profits are retained or used for expansion of the corporate business.

c) It is available to all corporations irrespective of size, growth potential or need of financial assistance.

d) It is inequitable in that it discriminates against unincorporated businesses.

e) It is inequitable in that it is unrelated to the taxable capacity of individuals to whom any benefit must ultimately accrue (the associated-corporation legislation relates the benefit to shareholders but not to their taxable capacity).

f) It is largely responsible for the complex associated-corporation legislation.

g) It inhibits tax reform.

3. The immediate and complete withdrawal of the low rate of corporation tax could create serious financial problems for many small profit corporations whose very creation was predicated on the existence of a low rate of corporation tax. Accordingly, the effects of the withdrawal of the low rate, or an increase in its level, should be mitigated in some appropriate way.

4. All of the alternative tax methods of assisting small or new businesses examined were subject, to a greater or lesser degree, to similar criticisms as are levelled against the dual rate of corporation tax.

5. The associated-corporation legislation is both complex and to some extent unsatisfactory. If the dual rate of corporation tax was retained, taxpayer ingenuity and the flexibility of corporate organization are such that detailed and specific legislation to combat successfully the avoidance of the intent of the associated-corporation legislation is unlikely, if not impossible, of achievement.

REFERENCES

1/ Budget Speech, Ottawa: Queen's Printer, 1949, p. 14.

2/ Budget Speech, Ottawa: Queen's Printer, 1960, p. 11.

3/ Royal Commission on Banking and Finance, Report, Ottawa: Queen's Printer, 1964, p. 44.

4/ Department of National Revenue Taxation Statistics, 1963, Ottawa: Queen's Printer, 1963, fully tabulated companies only, pp. 156-157.

5/ Some of the companies which earned a profit would not be subject to tax because of the application of prior year losses, and others, because of "associated" status, would not be eligible for the low rate but it is not possible to establish how many.

6/ Budget Speech, Ottawa: Queen's Printer, 1949, p. 14.

7/ Department of National Revenue Taxation Statistics, 1963, op.cit., fully tabulated companies only, pp. 160-161.

8/ Statutes of Canada, 1949, 2nd Sess., Chapter 25, section 18(1).

9/ The major complaint was said to have been that the test of direct or indirect control discouraged the formation of new corporations that depended upon capital furnished by existing corporations or by individuals who already controlled one or more corporations. Report of Proceedings of the Fourteenth Annual Tax Conference, Toronto: Canadian Tax Foundation, 1960, pp. 43-44.

10/ Statutes of Canada, 1950, Chapter 40, section 15.

APPENDIX J

A POSSIBLE TRANSITION TAX ON CORPORATE SOURCE INCOME

In Chapter 19 it was pointed out that the implementation of the recommendations for corporate source income, although they would lead to an increase in total tax revenues (from residents and non-residents) in the long run, would result in a deficiency in tax revenues over the transitional period. One means of meeting this deficiency, although it is not our primary recommendation, would be to impose a special temporary tax on shareholders. The tax would be sufficient to raise the necessary revenue from corporate source income in the transitional period to offset the initial revenue loss from integration. In the long run this revenue loss would be more than compensated by the other changes in the taxation of corporate source income that we have proposed.

We are satisfied that there is no general transition tax that would be both completely equitable for the shareholders of every corporation and administratively feasible. It is impossible to determine now whether the shareholders in a particular corporation relative to shareholders of other corporations would gain or lose as a result of integration. Nor would it be possible to do so after implementation of our proposals. While it may be possible to ascertain, for example, that the low income shareholders of a particular corporation are treated unfairly under the present law relative to upper income shareholders of the same corporation, it is usually impossible to determine whether the shareholders of a particular corporation as a group are being unfairly treated relative to the shareholders of another corporation.

Special Transition Tax

If there is to be a special transition tax on corporate source income, it could be determined and applied in the following way:

1. An amount, known as the "transition surplus", would be determined by

measuring the increase in the undistributed income of the corporation for the period of, say, five years 1/ preceding the date of the introduction of the integration system (the "transition date"). The undistributed income would be computed in accordance with the normal procedures now used under the Income Tax Act. Thus, all dividends paid in this period, including stock dividends and other deemed distributions, whether from tax-paid undistributed income or otherwise, would serve to reduce the transition surplus. From this aggregate there would be deducted the amount of any tax-paid undistributed income of the corporation at the transition date, whenever created, resulting from elections under section 105 of the Act or otherwise. In addition, as discussed below, the corporation should be allowed to make further elections similar to the present section 105 election on up to one half its transition surplus.

2. When each distribution or allocation was made subsequent to the transition date by the corporation to its shareholders (whether out of income on which corporation tax had been paid or as a return of capital), each resident individual shareholder would be deemed to have received additional income equal to the lesser of his portion of the transition surplus or the amount distributed or allocated to him. This deemed income would be included in the resident individual's income for tax purposes and taxed at full rates. Although it would be possible to allow the 20 per cent dividend tax credit on this deemed income, we do not so recommend because it would have a substantial effect on revenue that would have to be made up by increasing the number of years of undistributed income to be included in the transition surplus. The amount of the distribution or allocation on which the deemed income figure would be based would be the net distribution or allocation and not the grossed-up amount. If the shareholder was another resident corporation, it would not be subject to the special tax, but would include the deemed income in its own transitional surplus for allocation

to its own shareholders. The special tax would not be payable by non-residents because they would derive no benefit from integration and would continue to be subject to withholding tax on distributions in the same manner as at present.

3. It is not intended that the imposition of a transition tax should increase the total taxes on distributions over what would be payable under the present system. Therefore, we believe that an election similar to the present section 105 should continue to be available during the transitional period of, say, seven years. Although the use of this election by a corporation would result in its having to remit part of the transition tax, this appears to be the most equitable procedure for allowing shareholders to elect the manner in which they wish to pay the transition tax. Thus, we suggest that a corporation be permitted to elect to pay 15 per cent on one half of its transition surplus and thereby relieve its shareholders from having to bring that portion of the transition surplus into their income.

4. The special tax would be imposed as long as any transition surplus was on hand. However, to ensure that the period of time concerned did not become extended, and to prevent the undue deferment of the payment of this tax, the government might wish to provide that all transition surplus must be paid or allocated by some final date, say, seven years from the transition date.

5. The transition tax would be based on a deemed figure, even though the amount would be calculated by reference to actual distributions or allocations. It would be a special tax and would not in any way affect the other tax consequences of making a distribution or allocation as outlined in Chapter 19 and would not affect the basic tax accounts of the corporation. Thus, it would not involve any adjustment to the cost basis of the shares. The tax would be a form of arbitrary fee levied on shareholders which, only for purposes of the computation,

would be related to corporate distributions and allocations. Relating it in this fashion would also ensure that most shareholders would pay less tax and that no shareholders would pay substantially more tax on corporate distributions than they would have paid under the present legislation. The taxes payable are shown in Table J-1.

6. Many of the present "surplus-stripping" problems would remain in connection with the transition tax. It would probably be necessary to have special rules for the imposition of the tax on a sale of shares by a resident to a non-resident, to an exempt organization or to a security dealer.

While this description is rather specific, the details of the transition tax and the number of years to be taken into account in computing the transition surplus would be determined by the government after further study of the probable effect on revenue of the introduction of the proposed changes in the tax system.

A special tax in this form has a number of implications. The tax would essentially be based upon undistributed income accumulated over recent years. Therefore, it would amount to a tax on surplus. However, we do not believe that this would be inequitable because it would only take the surplus of recent years into consideration and most shareholders have anticipated that the withdrawal of this surplus through dividends would eventually involve some tax liability. We believe that it would be advantageous for the economy as a whole to have the full benefits of integration immediately available to new, to recently formed and to rapidly expanding corporations. Basing a transition tax on recently acquired undistributed income would minimize the tax on these three groups. In addition, the "capitalizing" of all the undistributed income on hand would benefit the old established companies with large surpluses by limiting the tax liability on distribution of their surpluses. However, it is reasonable to collect some tax from the shareholders of these corporations. Because surplus accumulated up to the

TABLE J-1

EXAMPLES OF THE TOTAL TAX ON A $100 POST-TRANSITION DIVIDEND OR ALLOCATION FROM A CORPORATION WITH AT LEAST AN EQUIVALENT AMOUNT OF TRANSITION SURPLUS ON HAND

Resident shareholder with 20 per cent marginal tax rate	
Ordinary dividend or allocation	$100.00
Grossed-up	200.00
Personal tax at 20 per cent	40.00
Credit for corporation tax	100.00
Refund	60.00
Transition Tax	
Deemed income of $50 at 20 per cent	10.00
Section 105 type election by corporation on $50 at 15 per cent a/	7.50
Personal tax (as above)	40.00
Total tax paid	57.50
Resident shareholder with 50 per cent marginal tax rate	
Ordinary dividend or allocation	100.00
Grossed-up	200.00
Personal tax at 50 per cent	100.00
Credit for corporation tax	100.00
Refund	-
Transition tax	
Deemed income of $50 at 50 per cent	25.00
Section 105 type election by corporation on $50 at 15 per cent a/	7.50
Personal tax (as above)	100.00
Total tax paid	$132.50

Note:

a/ It is assumed that the corporation elects to pay the 15 per cent tax on one half of the transition surplus.

transition date would not be subject to any further tax on distribution to the shareholders other than the special transition tax, most shareholders of corporations with accumulated earnings would be in a much improved situation even after payment of the tax.

This transition tax does not purport to be equitable in any absolute sense to the shareholder of a particular company relative to another shareholder in the same or another company. However, even though the impact of the tax might weigh relatively more heavily on some companies than on others, the potential inequities are much less serious than might otherwise appear because most shareholders have some diversification in their portfolios, often through investments in mutual funds and pension plans. High income individuals holding shares in private companies that have had low pay-out ratios in order to defer personal tax are less likely to have this diversification than others. The transition tax would be relatively heavy in the case of this group. This feature of the tax seems to us to be desirable.

Because the transition tax would not be imposed on the company and the undistributed income would, in effect, be attributed to shareholders, non-resident shareholders should, in general, be unaffected. We do not favour the imposition of a new tax on non-residents to recoup revenues lost in making a change from which they would not benefit.

Shareholders in private companies that in recent years have paid substantial dividends or have made section 105 distributions, even if these distributions were in effect made from surplus accumulated many years before, would pay little additional tax. This is desirable because these shareholders have already distributed and paid tax on a substantial portion of their corporate income. Also, if a corporation had acquired tax-paid undistributed income that it had not distributed, this would benefit its shareholders. This too appears equitable, because otherwise the shareholders would obtain no benefit from the payment of this tax on the corporation's undistributed income. In addition, because the right to a section 105

election would remain available for a limited period of time, many companies would be able to reduce the effective tax burden to their shareholders by making such an election.

Many small companies that could qualify for the accelerated capital cost allowance would be able to reduce or eliminate their ordinary income tax liability on corporate source income in the years immediately following the transition date, so that they should have available liquid funds with which to pay the special tax.

Shareholders in mining and petroleum companies or life insurance corporations would be subject to little, if any, transition tax as the undistributed income of these companies is usually relatively small. This would be a desirable result as our other proposals would generally increase the level of tax on these shareholders.

The cash position of most shareholders who did not realize share gains during the transitional period would, on balance, be improved relative to their current position, despite the necessity of paying the special tax. The tax refund on allocated corporate income would, on average, more than offset the special tax.

REFERENCE

1/ As a single time period would place a relatively new corporation in the same position as an older corporation that had been accumulating undistributed income for many years, it might be more equitable to also provide an alternative time period of, say, ten years. A company choosing the alternative would be permitted to reduce the transition surplus by an arbitrary amount of, say, 40 per cent to arrive at a figure similar to that obtained under the shorter time period. This alternative would be available even if the company had not been in existence for the full period of time in order to ensure that the newer companies would not be taxed relatively more heavily than the established corporations. The actual number of years that would be included in both of these computations would depend upon the amount of revenue required in the transitional period.

APPENDIX K

TAX CONCESSIONS TO THE MINING AND PETROLEUM INDUSTRIES

Historical Development

Although the three-year exemption from income tax for new mines, the depletion allowances and the deduction of exploration and development costs which are enjoyed by the mining and petroleum industries are difficult to justify at the present time when virtually all costs are deductible, a review of the historical development of these tax concessions gives some insight into the reasons for their existence.

Depletion Allowance. The depletion allowance was introduced in the Business Profits War Tax Act of 1916, and in general terms was intended to allow for exhaustion of the resource. No reference was made to an allowance for the cost of developing the resource; rather it was justified in terms of the value of the resource. This may be partly explained by the fact that the profits tax was to be levied only on profits in excess of a certain percentage of capital, and it was recognized that in an industry such as mining or petroleum the real capital values at the inception of the tax might be quite different from the costs recorded in the accounts. The depletion allowance might also have been justified as an indirect allowance for cost, since it does not appear that exploration and development costs were allowed at that time as a deduction in computing income. Once this concept was established for mining and petroleum companies in existence at the time of the introduction of the income tax, presumably it was difficult not to grant a similar allowance to new companies, even though no attempt has ever been made to tax these companies on the difference between the cost and the real value of the capital. Experience in the United States was similar and probably influenced the Canadian approach.

Under the Income War Tax Act of 1917, the Minister of National Revenue was given discretion to establish such an allowance for exhaustion as he deemed just and fair. Some time after 1928, the allowance was established

at 25 per cent of gross revenue, of which an amount calculated at 25 per cent of net revenue was viewed as a depletion allowance and the balance as an allowance in respect of development costs, although the meaning of these terms is not clear. In 1939 the first direct form of capital cost allowance emerged, a separate deduction being allowed by the Minister for a percentage of development costs, decreasing from 30 per cent to 10 per cent until the cost was fully written off. The Minister continued to grant a depletion allowance of 25 per cent of the net income remaining after deduction of the development costs. In 1941 the depletion allowance for operators was increased to 33.33 per cent at which level it has remained to the present day.

In 1949 the calculation of the depletion allowances was set out in the Regulations. In their application to the petroleum industry, controversy ensued as to whether the depletion allowance was to be based on a "well-by-well" calculation, in which case only the profits of profitable wells would be considered, or whether it would be based on an "overall" calculation, in which case losses of unprofitable wells would have to be deducted as well as exploration, development and other operating expenses not related to the profitable wells. The Regulations were amended several times as the government attempted to ensure the latter treatment, and the result was that only in the years 1949 and 1950 could a well-by-well basis be used.

Despite the changes which occurred after 1939 in the treatment of costs, referred to below, there was no basic change in the depletion allowance aside from an increase in the rate for operators from 25 per cent to 33.33 per cent. The liberalization of the allowance of costs did, of course, have an effect on the depletion allowances which are based on income after deduction of costs. In addition to this operator's depletion allowance, there has been a "non-operator's" depletion allowance of 25 per cent of gross revenue and also a depletion allowance granted to shareholders varying from 10 per cent to 20 per cent of the dividend, depending upon the proportion of the company's income directly or indirectly derived from oil and mining operations.

Three-Year Exemption for New Mines. The three-year exemption of the income of new mines was introduced in 1936 as a measure to encourage the development of the mining industry. At the time of its introduction, the Minister of Finance stated:

> "Exploration and development require expenditure of large amounts of capital over a considerable period of time. Private enterprise, therefore, can only be induced to enter the field if the prizes to be gained for the relatively few successes are attractive." 1/

Originally intended for a period of only a few years, it has been in the legislation in roughly the same form ever since.

Deduction of Exploration and Development Costs. In 1943, tax credits were introduced for certain drilling and exploration petroleum expenditures. In introducing this measure the Minister of Finance referred to the emergency conditions of the day and stated that it was the government's desire to remove as far as possible any barriers which taxation may impose in the way of the search for oil. The tax credit rates corresponded to the corporation tax rates (in some cases exclusive of excess profits tax) of the time, and accordingly the tax treatment was equivalent to allowing the expenditures as a deduction in arriving at taxable income.

When amendments to the tax legislation were considered in 1945, it was contended by some that the write-off of mining depreciation and pre-production costs tended to defeat the purpose of the three-year exemption, and in 1947 gold mines were permitted to defer deducting certain expenses during the exempt period. With the introduction of the present depreciation system in 1949, the claiming of all capital cost allowances became permissive, and an incidental effect of this change was to permit mining companies to defer claiming capital cost allowances until after the three-year exemption had expired.

A further major change in the treatment of costs came in 1948 when all exploration and development costs other than the costs of rights, bonus

payments and purchased properties became deductible immediately to the extent of the income of the taxpayer, any unabsorbed balance being available for indefinite carry-forward. The last major change occurred in 1962 when the costs of oil rights and properties became deductible in the same manner as exploration and development costs.

Anomalies and Technical Difficulties

There are a number of features in the provisions for the three-year exemption which present anomalies, loopholes and problems in administration. For example, there is considerable imprecision in the definition of what constitutes a new mine, and some of the mines which qualify may be in an ore body already known to exist and from which ores are being extracted at a nearby location, or the ore taken from the ground may be processed by an existing plant.

It may be noted that the income which is exempt under the legislation may be considerably greater than the income determined under ordinary business principles, because capital cost allowances and the amortization of pre-production costs may be deferred until after the exempt period. While the results from the Mining Survey 2/ in this respect were incomplete and revealed wide fluctuations in experience, on the average the income for corporate purposes was about 72 per cent of the tax-exempt reported income. This would indicate that the three-year exemption is in effect at least a four-year exemption in terms of normal business profits. In addition, mining income for this purpose is treated as including income from a refining operation carried on by the taxpayer, but not the income from a refining operation carried on by another taxpayer. The exemption of income also provides an incentive for changing operating procedures in order to maximize income during the exempt period, although it is extremely difficult to determine the extent to which this has affected actual operations and, as far as we have been able to ascertain, it is not a material factor.

As in the case of the three-year exemption, income eligible for the 33.33 per cent depletion allowance may include income from a refining operation carried on by the taxpayer, but not income from such an operation carried on by another taxpayer. In addition, it is somewhat anomalous that all exploration costs must be deducted in arriving at the income subject to depletion even though they may bear no necessary relation to the mine or petroleum well. This does not, however, seem to be a matter of contention in the mining industry, probably because the exploration costs are relatively smaller than in the oil industry, and a mine is often operated by a separate company that is not engaged in outside exploration.

One of the inherent difficulties in the tax concessions granted to the oil industry is the conflict between the two main concessions—the depletion allowance on production income and the fast write-off of costs. For example, the fast write-off of exploration and development costs has to be made against income subject to a lower rate of tax because of the depletion allowance. On the other hand, the effect of the depletion allowance is reduced because the fast write-off of exploration and development costs means that income, and therefore an effective claim for depletion allowance, is deferred.

Taxpayers have resorted to various methods of deriving the maximum benefit from these two incentives by separating them. For the years 1949 and 1950, the Home Oil Company was able to establish that the depletion allowance should be calculated on a well-by-well basis, 3/ which meant that exploration and development costs not related to the producing well were not deductible in computing the income subject to depletion. Another taxpayer, Imperial Oil Ltd., was unsuccessful in its attempt to establish such a basis for 1951 under the Regulations as amended 4/. We understand that an integrated oil company is able to organize separate corporations in such a way that exploration costs can be deducted against refining and marketing income which would otherwise be taxed at full rates, and

can claim depletion allowance on the production income without deduction of such exploration costs. Although this use of separate corporations would effectively defeat the general basis for calculating depletion as set out in the Regulations, no action has been taken by the government to require consolidation of related corporations for the purpose of determining the depletion allowance.

Problems Arising from Present
Tax Concessions

The relation between the depletion allowances and the fast write-off of costs was the basis of various proposals to us. One was that 150 per cent of exploration costs should be deductible. Another was that the depletion allowance should be based on 25 per cent of gross revenue, that is, before operating expenses and exploration and development costs. Based on future projections submitted to us by the Canadian Petroleum Association, this suggestion would, in the case of an oil company with a continuing exploration programme, virtually eliminate the taxation of any income from the exploration and production of oil. Their projected figures for calculating the income from a barrel of crude oil were as follows:

Selling price		$2.40
Royalty		.35
		2.05
Operating expenses		.49
		1.56
Exploration costs	$ .67	
Development costs	.30	.97
Income		$ .59

The suggested 25 per cent gross depletion allowance would give an extra deduction of 51 cents (25 per cent of $2.05) per barrel, reducing the income per barrel to 8 cents.

Since we have recommended that the depletion allowances be discontinued, it is not necessary to assess the merits of these proposals. An incidental result of our recommendation would be to bring the existing problems to an end.

A significant anomaly has emerged in respect of potash development. One method of extraction which involves drilling holes into the earth is considered an oil well operation, whereas another which involves extraction on the surface is considered an open pit mining operation, eligible for the three-year exemption for new mines. This difference in treatment has arisen merely from the physical characteristic of the operation, which bears no relation to need for tax relief. With the adoption of our recommendation for removal of the three-year exemption for new mines, this anomaly would be ended.

The tax advantage which an integrated mining or petroleum company enjoys in relation to an unintegrated company reflects the fact that, under the income tax system, the taxpayer with income against which to offset costs of developing new ventures is in an advantageous position, because he can have his costs immediately recognized for tax purposes. This inherent discrimination of the tax system is accentuated in the natural resource industries because of the basic nature of the industries and the special tax provisions which have been adopted to date.

Because there is a long delay between the outlay of expenditures to find mining and petroleum reserves and the resulting income, and because there is a continuing need to find new reserves for the future, deductibility of the expenditures as they occur can be extremely important. For companies engaged solely in production, the acceleration of the write-off of expenditures beyond a certain degree is of little significance, because even a moderate degree of acceleration will permit income tax to be deferred for many years. Furthermore, if provision is made for the accelerated write-off of expenditures, a special incentive based on income, such as a percentage depletion allowance, is not of much consequence for such companies because their income, and therefore their right to claim depletion, may be deferred until far into the future. For an integrated company, however, it may be possible to absorb immediately expenditures that will produce

long-term benefits and also to claim a depletion allowance relatively quickly. This is especially true where the form of corporate organization has enabled expenditures to be charged against income other than production income and depletion allowances to be calculated on the production income. Thus, while the tax provisions have enabled the unintegrated producing company to defer payment of tax for a long time, they have provided an even greater advantage to the integrated company.

The recommendations for removal of the percentage depletion allowances will serve to reduce this sharp discrimination between the integrated and unintegrated companies.

Representations have often been made that the United States operator has an advantage in carrying out oil operations in Canada compared with the Canadian operator, because of the operation of United States income tax laws. Where a United States corporation is operating in Canada through a branch, this advantage appears to arise from the possibility of writing off costs of the Canadian operations against other income in the United States, and from the fact that United States law provides for depletion at 27.5 per cent of gross revenue, subject to a maximum of 50 per cent of net income, on a property-by-property basis. These advantages are not unlike the advantages of a Canadian integrated company over a Canadian unintegrated company. For a United States individual, the relative advantage arises from his ability to deduct costs incurred outside the United States against all his income, and from certain anomalies inherent in the United States method of taxation which permit a tax advantage to be gained through the generous allowances of costs and the preferential treatment of proceeds from oil properties. On the other hand, a United States corporation or individual is not allowed, under United States tax laws, the immediate deduction of all exploration and development costs which is generally permitted to a Canadian corporation engaged in oil operations.

REFERENCES

1/ *House of Commons Debates*, May 1, 1936, p. 2386.

2/ See Chapter 23, Reference 11/.

3/ *Home Oil Ltd*. v. *M.N.R*. [1955] S.C.R. 733.

4/ *Imperial Oil Ltd*. v. *M.N.R*. [1960] S.C.R. 735. Imperial Oil claimed that the income subject to depletion amounted to $39,071,000, whereas the Minister contended, and the Supreme Court held, that the income subject to depletion was only $2,370,000. Of the difference, $20 million related to exploration and development costs and the balance to the treatment of loss wells and the unrealized profit on oil and gas produced and retained in inventory.

APPENDIX L

TAXATION OF FOREIGN INCOME UNDER THE UNITED STATES INTERNAL REVENUE CODE

This is an outline of certain aspects of the taxation of foreign income under the United States Internal Revenue Code. Paramount attention is given to recent legislation, particularly the Revenue Act of 1962 which introduced new and extensive rules governing international business. Certain complex rules have been reduced to generalizations which necessarily disregard many qualifications and special rules. All references are to the Internal Revenue Code of 1954 and Regulations thereunder, as amended to April 30, 1966.

BASIC RULES

World Income

Citizens, residents and corporations incorporated in the United States ("domestic corporations") are subject to tax on income from all sources whether domestic or foreign 1/.

Foreign Tax Credit or Deduction

A taxpayer may elect to deduct foreign income taxes paid on foreign source income or to credit the foreign taxes against United States taxes otherwise payable on the foreign source income 2/. A credit for foreign taxes has been provided in the Code in some form since 1918. Foreign taxes creditable include provincial and municipal income taxes.

A United States corporation, but not an individual, is also permitted an indirect credit for foreign taxes under section 902. This section permits a United States corporation in calculating its United States tax on dividends from a foreign corporation to apply the United States tax rate to the profits, calculated by United States rules, of the foreign corporation before foreign income taxes and then to deduct from the United States taxes otherwise payable all the foreign taxes paid, to the extent that the dividend received is deemed to have been paid out of the income of a foreign corporation subject to foreign tax.

The indirect credit is available only to a domestic corporation which owns 10 per cent or more of the voting stock of the foreign corporation. A corporation may also credit its share of eligible taxes if the foreign corporation in turn owns 50 per cent or more of the voting stock of a subsidiary of the foreign corporation, that is, a second-tier corporation. No credit is available for taxes paid by third and more remote tiers.

A United States taxpayer is further entitled to elect whether to take an "overall limitation" or a "per country limitation" on the foreign tax credit claimed 3/. If the former is elected, all foreign source income is lumped together and one calculation is performed which includes all foreign income taxes paid on the income in question. If the latter is elected, a separate calculation is performed for each country. The overall limitation may not be applied to certain interest income, generally, interest not derived from the active conduct of trade or business or from a corporation in which the taxpayer owns at least 10 per cent of the voting stock. This qualification was added by the Revenue Act of 1962. Any excess of credit over United States taxes payable, which the credit utilized in any one year may not exceed, may be carried back to the two taxable years next preceding the one in which the excess credit is generated and carried forward for five succeeding taxable years.

Source of Income

Determination of the source of income is basic to the United States system of taxation of income having a connection with the United States. It is specially important in the operation of the foreign tax credit rules because of the possibility that a foreign country may tax income which is regarded under United States law as being United States source income. In such a case, the United States taxpayer may be subject to double taxation, unless relieved by a tax convention, because he will not be allowed credit under United States tax law for taxes paid on income which is deemed by United States law to arise from United States sources.

The source rules are briefly as follows 4/. The source of interest income is ordinarily the place of residence of the payor. For this purpose, all

domestic corporations are residents of the United States whether or not they do business or own property in the United States, and foreign corporations are residents if they are engaged in trade or business in the United States. There are three exceptions to the payor test. One takes into account the possibility of tracing the source of interest to the source of the income of the payor and the other two exceptions apply to certain aspects of the banking business.

In determining the source of dividend income, the place of incorporation and of the source of the income of the paying corporation are taken into account in the application of certain relatively complex rules. The source of rent and royalty income is generally the place of location of the property giving rise to the income or the place where the property is used or is usable under licence. Services are deemed to give rise to income in the place where the services are performed. The source of income from the sale of real property is where the property is located, and income derived from the purchase and sale of personal property is deemed to be derived from the place where title to the goods passes to the buyer under the contract. If bare legal title is retained by the seller, the sale takes place where beneficial ownership and risk of loss is passed 5/. The source rule on the purchase and sale of personal property applies to the sale of securities as well as to goods and a sale includes an exchange. However, income from the production and sale of personal property is generally treated as derived partly from the place of production and partly from the place of sale.

SOME SPECIAL RULES— EXEMPTIONS AND LIMITATIONS

Earned Income of Citizens Resident Outside the United States

A United States citizen resident abroad is not subject to United States tax on foreign source income for personal services:

1. Up to $20,000 if he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year; and

2. Up to $25,000 after three consecutive years of bona fide residence.

A taxpayer who has not established residence abroad may exclude from income subject to United States tax up to $20,000 of compensation earned abroad if he has been present in a foreign country for 510 full days (17 months) in a period of 18 consecutive months. If the 18-month period begins or ends during a taxable year, the exemption is limited to the proportionate part of $20,000. Special provisions cover other situations involving partial tax years 6/.

Western Hemisphere Trade Corporations

The law includes several qualifications to the general rule that a United States corporation is fully taxable currently on all its income from whatever source. For example, a United States corporation which is a "western hemisphere trade corporation" is granted, under provisions introduced in 1942, a deduction of approximately 14 percentage points for specified types of operations in the western hemisphere outside the United States. Briefly stated, a western hemisphere trade corporation is a United States corporation all of the business of which (other than incidental purchases) is done in any country or countries in North, Central or South America or in the West Indies, 95 per cent or more of the gross income of which for the three-year period immediately preceding the close of the taxable year was derived from sources outside the United States and 90 per cent or more of the gross income of which for the same period was derived from the active conduct of a trade or business 7/. A western hemisphere trade corporation subsidiary may be included in a consolidated return with a fully taxable United States parent corporation 8/ and, as a result of the 1964 amendments to the Code, is enabled to pass dividends to the parent without additional tax on the dividend, when it is included in a consolidated return. The credit for foreign taxes is available, but the credit is reduced to prevent the spread of the benefit or the preferential tax rate accorded to the western hemisphere trade corporation to other corporations in the group when an overall limitation is used and the taxable income of the western hemisphere trade corporation is derived from different countries than

is the income of the other corporations 9/. Dividends may also be paid to the parent without tax when an election is made by the parent to take a full deduction for dividends received 10/. Both the election to take the "100 per cent dividends received" deduction and the election to file a consolidated return result in loss of the separate surtax exemption of the western hemisphere trade corporation.

Possessions Corporations

Another provision of long standing grants certain exclusions from income for United States corporations engaged primarily in earning income from United States possessions 11/.

SOME SPECIAL RULES--INCLUSIONS

Foreign Personal Holding Companies

The foreign personal holding company provisions of the Code were enacted in 1937, primarily to prevent citizens and residents from avoiding United States tax by transferring their securities to a foreign holding company. Section 551 of the present Code provides that the undistributed foreign personal holding company income of a foreign personal holding company shall be included in the gross income of citizens or residents of the United States and domestic corporations to the extent of the dividend which would have been distributed to them had the undistributed foreign personal holding company income been paid out as dividends. A company is a foreign personal holding company if at least 60 per cent of its gross income, as defined for that purpose for a taxable year, is foreign personal holding company income (50 per cent in taxable years subsequent to the first taxable year in which the 60 per cent test is met) and more than 50 per cent in value of its outstanding stock is owned directly or indirectly at any time during its taxable year by or for not more than five individuals who are citizens or residents of the United States.

Foreign personal holding company income is defined as that portion of gross income which consists of dividends, interest, royalties, annuities, gains from the sale or exchange of stock or securities, gains from futures transactions in any commodity on or subject to the rules of a board of trade or commodity exchange, certain income relating to estates and trusts, income from personal service contracts where the individual who is to perform the services is designated in the contract or may be designated by some person other than the corporation in certain circumstances, income from the use of corporation property by shareholders, and rents which do not constitute 50 per cent or more of the gross income of the corporation. It is to be noted that the 60 per cent (50 per cent) requirement relates to the gross income of the foreign company. If that test is met, the United States shareholder must include in his gross income his allocable share of the entire taxable income, which is computed as if the corporation were a United States taxpayer.

The Revenue Act of 1962 —
"Controlled Foreign Corporation"

The scope of United States income tax law prior to the 1962 Revenue Act may be summarized as follows. Apart from the taxation of income from United States sources, and subject to the foreign personal holding company provisions of the Code, United States individuals and United States corporations could engage in business outside the United States through the instrumentality of a foreign corporation without subjecting the profits from such operation to United States taxes until the profits were repatriated. If they were repatriated in the form of dividends, they would be taxed as ordinary income subject to foreign tax credit. In the event of the sale or exchange of stock of a foreign corporation, which includes the liquidation of the foreign corporation except in special circumstances, the gain would be taxed at the special capital gain rate. The Revenue Act of 1962 made substantial changes in the taxation of the foreign activities of United States persons, both individuals and corporations, and the provisions of that Act will be set out somewhat more extensively than the prior law.

<u>Subpart F Income</u> <u>12</u>/. Certain types of income of controlled foreign corporations ("subpart F income"), even though undistributed, are included in the income of United States shareholders in the year the income is earned by the foreign corporation. In these cases, the shareholders are permitted to take the foreign tax credit to the same extent as if actual distribution had been made. United States shareholders are defined as "U. S. persons" with a 10 per cent stock holding. "U. S. persons", generally speaking, are United States citizens or residents and domestic corporations, partnerships, and estates or trusts. Each United States shareholder to be so taxed must either actually or constructively have at least a 10 per cent interest in the voting power of all classes of stock of a controlled foreign corporation. A foreign corporation is a controlled foreign corporation for this purpose only if more than 50 per cent of the combined voting power of all classes of stock is owned directly or constructively by these United States shareholders each having a 10 per cent or greater stock interest. To bring the provisions into play, a foreign corporation must be a controlled foreign corporation for a period of 30 days or more during any taxable year beginning after December 31, 1962, and only a person who is a United States shareholder on the last day such corporation is a controlled foreign corporation in any year is subject to United States tax on his <u>pro rata</u> share of subpart F income.

Two categories of undistributed income are taxed to the United States shareholders of controlled foreign corporations. The first category involves income derived from the insurance or reinsurance of United States risks and was designed to avoid practices resulting from the Life Insurance Company Income Tax Act of 1959. These provisions are not thought relevant to Canadian experience and will, therefore, not be discussed herein. The other category is referred to as foreign base company income. Foreign base company income is broken down into foreign personal holding income, foreign base company sales income and foreign base company services income. Collectively, the income derived from insurance or reinsurance of United States risks and foreign base company income is referred to as "subpart F income". The amount

of this which may be taxed in any year is limited to the earnings and profits of the controlled foreign corporation for the taxable year less deficits of that and other controlled foreign corporations not offset since 1959.

Earnings Invested in United States Property 13/. In addition to certain types of undistributed earnings being treated as if they were distributed to the United States shareholders of controlled foreign corporations, the Act also provided that increases in earnings invested in United States property, with certain exceptions, are to be taxed to United States shareholders. In general terms, United States property includes tangible property located in the United States, stock of a United States corporation, an obligation of a United States person and patents, copyrights and technical data acquired or developed for use in the United States. Earnings invested in United States property are treated first as arising out of subpart F income which means that, to the extent that subpart F income is taxed to United States shareholders, the income of the corporation will not again be taxed to the United States shareholders because of investments in United States property. Similarly, actual dividend distributions are treated first as being paid out of earnings invested in United States property, then out of subpart F income, and only finally, if any balance remains, out of the accumulated earnings and profits of the corporation which have not already been taxed to the shareholders. Only when actual dividends are treated as paid out of this latter category do they represent taxable dividends to the shareholders.

The earnings of a corporation classified as subpart F income or as investments in United States property give rise to taxable income to the United States shareholders only with respect to the portion of the earnings represented by the portion of the year in which the corporation was a controlled foreign corporation and the shareholders are taxed only on their allocable shares of the earnings. However, the provision applicable to increases in earnings invested in United States property is operative with respect to the total earnings of the controlled foreign corporation irrespective of when they are earned.

Foreign Base Company Income 14/. Foreign base company income consists of foreign personal holding company income, foreign base company sales income and foreign base company services income which are discussed below. Excluded from foreign base company income are dividend and interest income from 10 per cent related persons (and gains from the sale or exchange of the underlying investments) which are attributable to certain investments in less developed countries. Also excluded is certain income from shipping. Special rules apply where gross income giving rise to the foreign base company income represents less than 30 per cent or more than 70 per cent of the controlled foreign corporation's gross income. A further exception is provided for a foreign corporation where it is established to the satisfaction of the Treasury Department that the foreign corporation is not utilized to reduce taxes. The exclusions and special rules are discussed briefly below.

Foreign Personal Holding Company Income 15/. This category involves income which under other provisions of the Code already is defined as "foreign personal holding company income". Generally speaking, this is income which is passive in character. It includes income from dividends, interest, most royalties, annuities, etc. In this connection, the Senate Committee on Finance said:

> "Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U. S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying the postponement of the tax until the income is repatriated." 16/

Three modifications are made in the definition of foreign personal holding company income for the purposes of determining foreign base company income. First, all rental income is included in foreign base company income whereas under section 553 of the Code rental income is included as foreign personal holding company income only if it constitutes less than 50 per cent

of the gross income of the corporation. Second, rents and royalties received from an unrelated person and derived from the active conduct of a trade or business are excluded from foreign base company income, as are dividends, interest and gains from the sale or exchange of stock or securities derived in the conduct of a banking, financing or similar business, and also dividends, interest and gains from the sale of stock or securities derived from the investment made by an insurance company of its unearned premiums or reserves necessary for the proper conduct of its insurance business. In this second category, only income from unrelated persons will qualify for the exemption. The third type of exception is made for income received from related parties. This is designed to avoid taxing the United States shareholders on dividends received by a controlled foreign corporation from a related party where the United States shareholder would not have been taxed if he had owned the stock of the related party directly. For this reason, dividends and interest received from a related corporation, which is organized under the laws of the same foreign country as the controlled corporation and has a substantial part of its assets used in its trade or business located in that foreign country, are not included in the foreign base company income. Rents, royalties and similar payments received from a related party, whether or not incorporated in the same jurisdiction, are also excluded from foreign base company income if these amounts are received for the use of property within the country in which the controlled foreign corporation is incorporated. Also excluded from foreign personal holding company income in determining foreign base company income is interest received by a banking or financing business firm from a related person also engaged in the banking or financing business, if the business of each is predominantly with unrelated persons. Therefore, foreign base company income will not arise merely because of normal business transactions between two or more related financial institutions.

<u>Foreign Base Company Sales Income 17/</u>. Foreign base company sales income is derived from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person and is

manufactured, produced, grown or extracted outside of the country where the controlled foreign corporation is organized and the property is also sold for consumption or use outside of that country. The provisions also cover similar cases where the controlled foreign corporation does not take title to the property but acts on a fee or commission basis. The definition does not include cases where any significant amount of manufacturing, major assembling or construction activity is carried on with respect to the product by the selling corporation. However, activities such as minor assembly, packaging, repackaging or labelling are not sufficient to exclude the profits from the definition 18/.

The Senate Committee stated:

> "The sales income with which your committee is primarily concerned is income of a selling subsidiary (whether acting as principal or agent) which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income. This accounts for the fact that this provision is restricted to sales of property to a related person, or to purchases of property from a related person. Moreover, the fact that a lower rate of tax for such a company is likely to be obtained only through purchases and sales outside of the country in which it is incorporated, accounts for the fact that the provision is made inapplicable to the extent the property is manufactured, produced, grown, or extracted in the country where the corporation is organized or where it is sold for use, consumption, or disposition in that country. Mere passage of title or the place of the sale are not relevant in this connection." 19/

Also included in foreign base company sales income are operations handled through a branch rather than a corporate subsidiary operating outside the country in which the controlled foreign corporation is incorporated, if the combined effect of the tax treatment accorded the branch by the country of incorporation of the controlled foreign corporation and the country of operation of the branch is to treat the branch substantially the same as if it were a subsidiary of a foreign corporation organized in the country in which it carries on its trade or business.

Foreign Base Company Services Income 20/. Foreign base company services income is derived from the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or similar services,

but only where they are performed for or on behalf of a related person and are performed outside the country under the laws of which the controlled foreign corporation is created or organized. Not included is income derived in connection with the performance of services which are directly related to the sale or exchange by the controlled foreign corporation of property manufactured, produced, grown or extracted by it and which are performed prior to the time of the sale or exchange, or of services directly related to an offer or effort to sell or exchange such property.

As in the case of sales income, the purpose of including foreign base company services income is to deny tax deferment where a service subsidiary is separated from the manufacturing or similar activities of a related corporation, and is organized in another country primarily to obtain a lower rate of tax for the service income.

The 30-70 Rule 21/. The three categories of income described above which are called foreign base company income are taxed to the United States shareholder of a controlled foreign corporation only if the foreign base company income amounts to at least 30 per cent of the gross income of the corporation. If gross income giving rise to the foreign base company income exceeds 70 per cent of gross income, the entire gross income (reduced by certain deductions) of the corporation is treated as foreign base company income. Between these limits, only the actual foreign base company income is taken into account.

Qualified Investments in Less Developed Countries 22/. Although otherwise classified as foreign base company income, dividend and interest income and gains from the sale or exchange of qualified investments in less developed countries are excluded from subpart F income to the extent that these amounts are reinvested in qualified investment in less developed countries 23/. Provision is also made for an increase in the income taxable to the United States shareholders whenever there is a decrease in qualified investments in less developed countries, to the extent they were initially attributable to dividends, interest or gains of the type referred to above.

Qualified investments in less developed countries consist of stock of a less developed country corporation and obligations of such corporations which at their time of acquisition by the controlled foreign corporation had a maturity of one year or more. However, for either the stock or obligations to qualify, the controlled foreign corporation must own 10 per cent or more of the voting power of all classes of stock of the less developed country corporation and the investment must be held for six months. Qualified investments also include obligations of a less developed country.

Less developed country corporations fall into two categories. One category includes foreign corporations incorporated in the less developed country which are engaged in the active conduct of a trade or business, which derive 80 per cent or more of their income from sources within less developed countries and which have 80 per cent or more in value of their assets in property generally used in a trade or business in less developed countries or in certain other specified types of associated property. The other category is foreign corporations, not necessarily incorporated in a less developed country, receiving 80 per cent or more of the gross income from shipping or airline activities connected with less developed countries.

To the President of the United States is delegated the power to designate a country or territory a less developed country for the purposes of the Code. However, expressly excluded from the category are 21 countries, generally the most highly developed economically. Countries within the Sino-Soviet Bloc are also excluded. The President may not terminate such designation unless at least 30 days prior to such termination he has notified the Senate and the House of Representatives of his intention to terminate the designation.

The concept of less developed country corporations is also used, as noted above, in connection with the indirect credit for foreign taxes and, as will be noted, in connection with the United States tax treatment of the gain from the sale or exchange (including the liquidation) of a controlled foreign corporation.

Schedule of Minimum Distribution. A domestic corporation need not include subpart F income in its gross income if the foreign corporation generating the subpart F income has paid a substantial rate of foreign income tax, or made a substantial current distribution of earnings to the United States shareholders, or some combination of these factors exists. The object of the provision is to bring the overall United States and foreign tax rates up to 90 per cent of the United States rate. To qualify for the exception, the domestic parent corporation must make an election prior to the last date for filing a return and must determine whether the election will cover:

1. A single controlled foreign corporation;
2. A chain of controlled foreign corporations;
3. All controlled foreign corporations;
4. All controlled foreign corporations other than less developed country corporations.

The required distribution from one or more controlled foreign corporations depends upon the effective foreign tax rate and, generally, as the rate increases the percentage of profits required to be distributed decreases. For example, for taxable years beginning after December 31, 1964, if the effective foreign tax rate is under 9 per cent, the required minimum distribution of earnings and profits is 83 per cent; if the effective foreign tax rate is at least 43 per cent, no earnings or profits need be distributed.

For the purposes of the minimum distribution schedule, taxpayers may treat foreign branches of United States corporations as if they were wholly owned foreign subsidiaries distributing 100 per cent of their earnings. Special rules apply to certain United States possessions. Further, a taxpayer in computing the minimum distribution may omit income from a foreign corporation if it is established to the satisfaction of the Treasury Department that its earnings were blocked because of currency or other restrictions imposed by the laws of a foreign country.

The effective foreign tax rate referred to in the minimum distribution schedule is determined by expressing the income taxes, paid or accrued to the foreign countries or possessions of the United States by the foreign corporation or corporations involved, as a percentage of the earnings and profits of the foreign corporation or corporations plus the foreign taxes themselves. The earnings and profits must be determined according to rules substantially similar to those applicable to domestic United States corporations.

A distribution may be treated as being made in the year if paid within 180 days after such year 24/. If a United States shareholder in making its return applies the minimum distribution schedule and subsequently it is found that for reasonable cause it has not met the minimum schedule, subsequent distributions may be made by the controlled foreign corporation, as prescribed by regulations, and may be treated as if they had been made in the earlier qualifying period.

Export Trade Corporations 25/. Certain income of export trade corporations is excluded from subpart F income. To qualify for the deduction of export trade income, 90 per cent or more of the controlled foreign corporation's gross income for the three-year period preceding the close of the current taxable year must have been derived from sources outside the United States, and 75 per cent of the corporation's gross income must have reflected export trade income which is defined as the net income from one or more of the following transactions:

1. The sale to unrelated persons for export from the United States of goods manufactured, grown, produced or extracted in the United States ("export property"), and services in respect of the installation or maintenance of such export property.

2. Services performed in connection with the use outside of the United States of certain types of intangible property.

3. Commissions, fees or similar compensation from the use by an unrelated person of export property or from the rendering of technical, scientific or engineering services to unrelated persons and attributable to the use of export property.

4. Interest from evidences of indebtedness executed in connection with the payment for purchases of export property.

If 50 per cent or more of the gross income of the controlled foreign corporation is derived from income from agricultural products grown in the United States, the 75 per cent requirement does not apply.

The deduction is further limited to the lesser of (a) one and one-half times export promotion expenses properly allocable to the export trade income, or (b) 10 per cent of the gross receipts, accruing to the export trade corporation from the sale, installation, operation, maintenance, or use of property in respect of which the corporation derives export trade income, properly allocable to the export trade income which constitutes foreign base company income. Furthermore, the reduction may not exceed an amount which bears the same ratio to the increase in the investment in assets connected with the export trade as the export trade income which constitutes foreign base company income bears to the entire export trade income of the corporation for a year.

Foreign Tax Credit 26/. United States shareholders who are taxed on subpart F income, on a decrease in investments in less developed countries, or on the increase in earnings invested in United States property may take credit for foreign taxes paid by the foreign corporation if the shareholder is the person to whom such foreign credit would be allowed in the case of an actual distribution. Taxes so allowed as credit will not again be allowed as credits when actual distributions are made, nor will the distributions be taxable. However, where the foreign country imposes a tax directly on dividend distributions, such tax would not initially be taken into account when the shareholder at an earlier date was taxed on undistributed earnings of a controlled foreign corporation. These taxes on actual dividend payments will be allowed

as credits in the year in which the actual dividends are paid even though these dividends are not taxable to the United States taxpayer receiving them because of an earlier inclusion of these amounts in income. Adjustments are made in the overall and per-country limitations to keep these limitations from reducing the creditable taxes in such cases below what could be credited if the income taxed and taxes attributable to this income had been taken into account in the same year. If the taxpayer has insufficient United States income tax against which to offset such credits in the year of the actual distribution, refunds are allowed.

Adjustment to Basis of Stock 27/. Because a United States taxpayer will be subject to taxes on the gain from the sale or exchange of stock in a controlled foreign corporation (including a liquidation), it is necessary, where amounts not actually distributed to a taxpayer are nevertheless taxed to him, to increase his basis for the stock in the controlled foreign corporation by the amounts so taxed to him. If subsequently actual distributions are made which do not result in any tax to the shareholder because of the prior tax payments by him, the basis of the stock is reduced accordingly.

Election of an Individual to be Treated as a Corporation 28/. An individual shareholder who is subject to the subpart F rules may elect to be taxed on that portion of his income as if he were a corporation. This is designed to equate his position to that which would have obtained if he had invested through a domestic corporation rather than directly in a foreign corporation.

Gain from Sale or Exchange of Stock 29/. Prior to the 1962 Revenue Act, it was possible to distribute to a United States shareholder earnings accumulated by a foreign corporation merely by paying tax at capital gain rates on such earnings included in the gain. This could be accomplished either by the sale or exchange of the stock in the foreign corporation or by the liquidation of the company. It was also theoretically possible to realize on earnings accumulated by a foreign corporation without payment of any income tax at all in the United States by the use of a tax-free reorganization 30/ or through the

use of a tax-free liquidation 31/. However, to achieve this end, it was necessary to obtain from the Commissioner of Internal Revenue an advance ruling that the transaction was not "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes" 32/. Generally, the Commissioner was unwilling to grant such approval where an appreciable amount of earnings and profits had been accumulated in a foreign corporation.

The 1962 Revenue Act added section 1248 of the Code which applies to any shareholder who owns 10 per cent or more of the total combined voting power of the stock of a foreign corporation at any time during the five-year period ending on the date of sale or exchange, but only if the corporation was a controlled foreign corporation at any time during the period that the stock was owned by the shareholder. The 10 per cent ownership is determined under the constructive ownership stock rules which apply to subpart F income and are contained in section 958 of the Code. Section 1248 applies to any sale or exchange or to any surrender of stock to the corporation for redemption in a transaction which would be treated as a sale or exchange under sections 302 or 331 of the Code (a buy-out or a total or partial liquidation). When there is a gain on the transaction, there is included, as a dividend, in the gross income of the person surrendering the stock the portion of such gain attributable to the earnings and profits of the foreign corporation allocable to the stock surrendered, accumulated while the shareholder held the stock during the period in which the corporation was a controlled foreign corporation in taxable years beginning after December 31, 1962.

If the shareholder surrendering the stock is a corporation, it is entitled to a credit for foreign taxes paid by the foreign corporation in the same manner and to the same extent as it would be entitled to such credit in the case of any other dividend received from a foreign corporation. If the shareholder is an individual, the tax to be paid by him is not to be greater than the sum of the following amounts:

1. The excess of the United States income taxes which would have been paid by the foreign corporation with respect to its income if it had been a domestic corporation over the foreign income taxes actually paid by such corporation.

2. The amount of capital gains which would have resulted to the shareholder on the surrender of his stock, if the amount actually received by him on such surrender were diminished by the first amount described above.

The limitation does not apply unless the taxpayer establishes the amount of foreign taxes to be taken into account.

The earnings and profits for the purposes of this section do not include any amount attributable to gains on sales made in the course of a liquidation if these sales would have been treated as tax-free sales on liquidation had the corporation been a domestic corporation. Further, the section does not apply to earnings and profits accumulated by a foreign corporation while it was a less developed country corporation if the stock sold or exchanged was owned for at least ten years by the United States person before the date of the sale or exchange. A transfer of stock by death is viewed as not interrupting the continuous ownership.

The section also provides that any item of gross income of the foreign corporation treated as income derived from sources within the United States is not to be included in the earnings and profits to be taken into account. Also, earnings taxed under subpart F will not be taxed a second time under this section. The provision does not apply to distributions to pay death taxes 33/ or to gain realized because of "boot" on a reorganization exchange 34/. It likewise does not apply to any amount which is treated under any other section of the Code as a dividend, as a gain from the sale of an asset which is not a capital asset, or as a short-term gain. Unless the taxpayer establishes the amount of the earnings and profits of the

foreign corporation to be taken into account, the entire gain from the sale or exchange is considered a dividend.

Sale or Exchange of Patents, Copyrights and Similar Property. Section 1249 of the Code, added by the Revenue Act of 1962, provides that gain from the sale or exchange after December 1962 of a patent, invention, model or design (whether or not patented), a copyright, a secret formula or process or any other similar property right to any foreign corporation by a United States person which controls such foreign corporation is to be treated as ordinary income rather than as capital gain if, but for the section, the gain would be entitled to capital gain treatment under the Code. The provision does not apply to gains from the sale or exchange of trade marks. For the purposes of the section, control means the ownership directly or indirectly of stock possessing more than 50 per cent of the total combined voting power of all classes of stock and ownership may be determined by the constructive ownership rules of section 958.

Allocation of Income and Deductions

Section 482 of the Code provides:

> "In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Existing regulations introduce the concept of "true taxable income" to apply in the case of a controlled taxpayer and to mean the taxable income which would have resulted to the controlled taxpayer had it in the conduct of its affairs dealt with the other member or members of the group at arm's length 35/. The Regulations state that the purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining according to the standard of an uncontrolled taxpayer

the true taxable income from the property and business of a controlled taxpayer 36/. Further, the Regulations state:

> "Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to a case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." 37/

More extensive regulations have been proposed to deal with specific classes of cases, as follows: 38/

1. An arm's length interest rate must be charged on loans between members of a controlled group. The proposed regulations list as pertinent factors the amount of the loan, the security involved, the credit standing of the borrower, the interest rate prevailing at the situs of the lender or creditor for comparable loans, and other relevant facts. If the creditor was not regularly engaged in the business of lending to unrelated parties, and if the taxpayer cannot establish to the satisfaction of the district director an appropriate rate, a rate fixed by the parties between 4 per cent and 5 per cent will be acceptable or, if they have not fixed such a rate, a rate of 5 per cent will be deemed to be appropriate.

2. The price for services performed by one member of a controlled group for another may be determined on the basis of their cost. No allocation will be made under the proposed regulations if the party rendering the services has itself made an allocation to reflect these services "by employing in a consistent manner a method of allocation which is reasonable and in keeping with sound accounting practice". The costs to be taken into account are set out in detail.

3. An arm's length rental charge must be made for the use of tangible property supplied by one member of a controlled group to another. The approach taken to establish an arm's length rental charge is similar to that applied to determine an arm's length interest rate.

It is expected that regulations will be proposed shortly to deal with inter-company pricing of goods and the transfer of intangibles. Litigation which promises to lay down important principles in connection with inter-company pricing for goods is presently under way in the United States Court of Claims.

TRANSFER OF PROPERTY TO FOREIGN CORPORATIONS

Under section 351 of the Code, no gain or loss is recognized for tax purposes if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in the corporation and immediately after the exchange such person or persons are in control of the corporation. Control is defined to mean the ownership:

1. Of stock having 80 per cent of total voting power, and

2. Of 80 per cent of all other stock 39/.

However, under section 367 transfers to a foreign corporation do not qualify for this treatment unless, before such exchange, a ruling has been obtained that the "exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes" 40/. Property for this purpose includes patents, trade marks, copyrights, plans, drawings, designs, specifications, secret processes, secret formulae and other like property, as well as other assets. Where the Internal Revenue Service is satisfied that there is a bona fide business purpose for the transfer, or that the income tax in the foreign country will be at least as high as the United States income tax if the operation were conducted through a domestic corporation, the Internal Revenue Service will generally grant a favourable ruling. In the absence of

a ruling, any difference between the fair market value of the property transferred and its tax base to the transferor is taxable at the capital gain rate or the income rate, depending on the nature of the property. Section 367 is designed to prevent avoidance of United States taxes in various ways, including transferring property to a foreign corporation and then selling it at a gain free of United States tax.

TRANSFER OF SECURITIES TO FOREIGN ENTITIES

Following the principle of section 367, the Code also provides that the transfer of stock or securities by a citizen or resident of the United States or by a domestic corporation or partnership or by a trust which is not a foreign trust to a foreign corporation as paid in surplus or as a contribution to capital or to a foreign trust or partnership is subject to an excise tax of 27.5 per cent on the excess of the value of the stock or securities over their tax base in the hands of the transferor 41/. The tax does not apply if, before the transfer, it has been established to the satisfaction of the Internal Revenue Service that such transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes 42/. It is also provided that the tax may be abated, remitted or refunded if, after the transfer, it is established that the transfer was not in pursuance of such a plan 43/.

FOREIGN TRUSTS CREATED BY UNITED STATES GRANTORS

Prior to the Revenue Act of 1962, foreign trusts could be used to accumulate income free of United States tax if their income was not from United States sources. Tax-free distribution of the accumulated income of a trust was possible in several situations. The 1962 Act provided for taxing United States beneficiaries on distributions received from foreign trusts, which are created by United States grantors, settlors, or transferors, in substantially the same manner as if the income had been distributed to the beneficiary currently as earned, instead of being accumulated in the trust. The

new provision applies to foreign trusts to the extent money or property has been transferred directly or indirectly by United States persons or under the will of a decedent who was a United States citizen or resident. The amendments are effective for trust distributions made after December 31, 1962, out of income accumulated after 1953, regardless of the time the trust was created. The rules are set out in several sections applicable to trusts and estates.

INFORMATION RETURNS

Foreign Personal Holding Companies 44/

Officers, directors and 50 per cent shareholders must file annually an information return which covers identification of shareholders, plans for liquidation, and organizations and reorganizations which have taken place. Officers and directors must also report annually gross income, taxable income, and total and undistributed foreign personal holding company income.

Controlled Foreign Corporations 45/

Citizens, residents and domestic corporations, partnerships, trusts and estates that control a foreign corporation (more than 50 per cent in value of stock or more than 50 per cent of voting power) are required to report annually extensive information about the foreign corporation and its subsidiaries, including current earnings and profits, foreign taxes paid or accrued, distributions, balance sheet and profit and loss statement, certain transactions with related persons and a list of United States persons owning 5 per cent or more in value of any class of stock. In addition to the usual penalties for failure to file and for filing false returns, such default may be penalized by a reduction of credit for foreign taxes under section 6038. This section, which existed in the Code prior to the 1962 Act, was subtantially stiffened and expanded as part of the new legislation affecting foreign corporations.

Under section 6046, each United States citizen or resident who is or becomes an officer or director of a foreign corporation, 5 per cent or more

in value of the stock of which is owned by a United States person, and each United States person who owns 5 per cent or more in value of the stock of a foreign corporation, or adds 5 per cent or more in value to such stockholding, or reduces the holding to less than 5 per cent, must report within 90 days of the time that he acquires the status information as to certain shareholders, the organization or reorganization of the corporation, business activities, financial statements and assets transferred to the corporation. This section was also stiffened and expanded by the Revenue Act of 1962.

Transfer of Securities to
Foreign Entities 46/

A transfer of securities to a foreign entity must be reported at the time of the transfer.

Foreign Trusts 47/

Returns are required, within 90 days after the event, in connection with the creation of foreign trusts by a United States person and a transfer of money or property to such a trust. This requirement was added by the 1962 Act.

TREATIES

The United States has treaties with 22 countries for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income. Several other treaties have been signed but not ratified, or are in preparation. United States tax treaties are entered into by the President of the United States with the advice and consent of the United States Senate. Treaties receive further legislative implementation in the Code, which provides that income of any kind, to the extent required by any treaty obligation of the United States, is not included in gross income and is exempt from income tax 48/. Further, another section of the Code states that no provision of the Code applies in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of the enactment

of the Code 49/. The Revenue Act of 1962 provided that the latter provision is to be inapplicable in respect of any amendment made by that Act. However, it is thought that the only treaty affected was the Greek Estate Tax Treaty which has subsequently been modified.

Generally speaking, the tax treaties have their effect on the taxation of foreign corporations and persons doing business in the United States or investing in the United States, but do not affect the taxation of foreign income described in this appendix.

FOREIGN INVESTORS TAX ACT OF 1966

"The foreign investors tax bill of 1966...is designed to provide more equitable tax treatment for foreign investment in the United States." 50/ Therefore, it does not generally touch on the subject of this appendix. However, certain of the rules will be affected in some degree if the bill is passed in its present form and these are noted briefly.

The form of the bill at the date of this writing is as reported to the House of Representatives by the Committee on Ways and Means, April 26, 1966. Before it becomes law, it remains for the bill to be considered and approved by the House of Representatives, considered and approved by the Senate, in the usual course, after full consideration and report by the Senate Committee on Finance, the differences between the House and the Senate resolved and the bill signed into law by the President.

In the context of this appendix, the principal feature of the proposed Act is the provision which will subject to United States tax income which is presently regarded as foreign source income of a foreign corporation but which is effectively connected with the conduct of a trade or business within the United States, that is, which is earned by a foreign corporation which has a fixed place of business in the United States and which is attributable to the place of business. The provision applies only to three types of income from sources without the United States, namely, rents and royalties derived from the active conduct of a licensing business; dividends, interest

or gains on stock or debt obligations derived in the active conduct of a banking, financing, or similar business; and certain sales income attributable to a United States sales office. The sales income is not to be considered as effectively connected with a United States trade or business if the property is sold for use outside of the United States and an office of the foreign person outside the United States contributes materially to the sale. Thus, in this case foreign source sales income will be attributed to the United States trade or business only when the United States office is the primary place of the activity giving rise to the income. In the case of foreign source income where the products are destined for the United States, the income will be treated as effectively connected with a United States business to the extent the sales activity is carried on by the United States office. Income which is "subpart F income" is excluded from the operation of the provision.

REFERENCES

1/ Sections 1, 11 and 61.

2/ Section 901.

3/ Section 904.

4/ Sections 861 - 864.

5/ Regulation 1.861-7(c).

6/ Section 911.

7/ Sections 921 and 922.

8/ Sections 1501 - 1504.

9/ Section 1503(b).

10/ Section 243(a)(3).

11/ Section 931.

12/ Sections 951 - 972.

13/ Section 956.

14/ Section 954.

15/ Section 954(c).

16/ Report of the Senate Committee on Finance, Report No. 1881, 1962, p. 83.

17/ Section 954(d).

18/ Regulation 1.954-3(a)(4).

19/ Op. cit., footnote 16, p. 84.

20/ Section 954(e).

21/ Section 954(b)(3).

22/ Section 955.

23/ Section 954(b)(1).

24/ Regulation 1.963-3.

25/ Sections 970 - 972.

26/ Section 960.

27/ Section 961.

28/ Section 962.

29/ Section 1248.

30/ Sections 354 and 368.

31/ Section 332.

32/ Section 367.

33/ Section 303.

34/ Section 356.

35/ Regulation 1.482-1(6).

36/ Regulation 1.482-1(b).

37/ Regulation 1.482-1(c).

38/ Proposed Treasury regulations 1.482-1(d) and 1.482-2.

39/ Section 368.

40/ Section 367.

41/ Section 1491.

42/ Section 1492.

43/ Section 1494.

44/ Section 6035.

45/ Sections 6038, 6046 and 6679.

46/ Regulation 1.1494-1.

47/ Sections 6048 and 6677.

48/ Section 894.

49/ Section 7852(d).

50/ Report of the Committee on Ways and Means, House of Representatives, Report No. 1450, April 26, 1966, p. 1.

COMPARISONS OF TAX LIABILITIES ON CORPORATE SOURCE INCOME FROM SHARES FOR TAX UNITS AT DIFFERENT INCOME LEVELS AND WITH DIFFERENT FAMILY CHARACTERISTICS UNDER ALTERNATIVE ASSUMPTIONS UNDER THE CURRENT AND PROPOSED TAX SYSTEMS

The tax payable by, or on behalf of, resident individuals and families with only Canadian corporate source income from shares (plus family allowances where applicable) under the current and proposed systems is shown in the tables provided in this appendix.

Three comparisons are made:

Case 1: A typical public company distributing one half of its after-tax income as dividends.

Case 2: A typical private company distributing one half of its after-tax income as dividends.

Case 3: A typical private company distributing one half of its after-tax income as dividends and the balance under section 105.

A company's income is used to pay its taxes and to pay dividends to shareholders with the balance being saved or reinvested within the company. Shareholders therefore benefit both from receiving dividends and from the corporate savings, which add to the wealth of the company and increase the value of its shares. Shareholders also benefit from another increment in share value attributable to improved prospects for earnings. We refer to this increment as "goodwill" gains. Under our proposals corporation taxes paid by a company would benefit resident shareholders, as they could apply the corporation taxes against their personal tax liabilities. In summary, under the comprehensive definition of income a resident tax unit's income from holding equities would consist of four components:

1. Dividends;
2. Undistributed income of the corporation;
3. Realized goodwill gains; and
4. Corporation taxes paid.

In each of the three cases referred to in the tables which follow, assumptions are made about the relative importance of each of these components. These assumptions are specified in Table M-1.

Goodwill gains under our proposals would be taxable only upon realization, but as it is not practical to estimate when they would be realized we have computed the tax liabilities as though such gains were realized annually. For public companies we have assumed that goodwill gains are equal to cash dividends and we have taken cash dividends to be one half of profits after taxes. Primarily because of the limited marketability of the shares of private companies we have assumed that their goodwill gains are one half of those of public companies.

To assist the reader in interpreting the results shown in the computer-generated tables, 1/ an example is provided of the calculations made for a tax unit with given income and family characteristics for each of the three cases. These examples are given in Tables M-2 to M-4 inclusive. The example in Table M-2 corresponds to the result given in Table M, 1-1, column 1, in the row for a gross corporate source income of $10,000. The example given in Table M-3 corresponds to the result given in Table M, 2-1, column 4, in the row for a gross corporate source income of $8,000. The example given in Table M-4 corresponds to the result given in Table M, 3-1, column 5, in the row for a gross corporate source income of $100,000.

For each of the three cases, three computer tables are provided. The first table shows the difference in taxes under the current and proposed systems. The second shows the effective average rates under the current and proposed systems. The effective average rate is simply the ratio of taxes paid to income. The third provides estimates of the effective marginal rates under the current and proposed systems. The effective marginal rates are computed as the rate of tax on an additional $500 of income assuming that

the rate of tax paid by the corporation on this income is 50 per cent.

In Cases 1 and 2 it is assumed that one half of the after-tax corporate income is undistributed. This undistributed income would be subject to further tax under the current tax law if subsequently distributed. However, this tax may be deferred indefinitely and shareholders can avoid it by the sale of their shares. To give some indication of what this further liability might be, we show at the end of each example the amount of undistributed income remaining after the stipulated distribution. This figure appears only in the column under current tax law as, under our proposals, it is assumed that all of the corporate income is distributed or allocated to shareholders. In Case 3 it is assumed that a full distribution of income has been made under the current tax law so that no further taxes are payable under any circumstances.

The results of Case 3 should be interpreted with caution. Section 105 distributions are only attractive to shareholders with marginal rates in excess of 35 per cent, that is, with taxable incomes in excess of $12,000 under the current system. This corresponds to corporate source income of over $50,000 under the comprehensive tax base.

All of the results in the computer tables are presented in terms of gross corporate source income, which is comprehensive tax base income from the holding of corporate shares. This is not synonymous with cash dividends. To interpret the computer tables in terms of cash dividends, cash dividends should be multiplied by certain factors to obtain gross corporate source income. These factors are derived from the assumptions and estimates given in Table M-1. The factors are as follows:

Case 1 : $\frac{1.00000}{0.20192} = 4.9524$

Cases 2 and 3 : $\frac{1.00000}{0.27957} = 3.5769$

To be more concrete, if an unattached individual received annual cash dividends of $2,019.15 from a public company, and no other income, it is assumed that his gross corporate source income under the comprehensive tax base would be $2,019.15 x 4.9524 = $10,000. As shown in the example given in Table M-2 and in Table M, 1-1, column 1, in the row for a gross corporate source income of $10,000, the current tax liability on this income is $3,979. Under the proposal it would be $1,942. Both personal and corporation taxes are taken into account in all of these calculations.

All of the comparisons given in this appendix are based on the assumption that the full corporation tax is borne by the shareholders and that no part of any reduction in the tax on corporate source income would be shifted in the form of lower prices for goods and services sold or higher prices for goods and services purchased.

All of the comparisons given in this appendix assume that the shareholder is a resident with only Canadian corporate source income from shares.

REFERENCE

1/ The tables were produced using programmes presented in General Income Tax Analyzer by John Bossons, a study published by the Commission.

TABLE M-1

ASSUMED PRESENT COMPOSITION OF A SHAREHOLDER'S CORPORATE SOURCE INCOME DERIVED FROM TYPICAL PUBLIC AND PRIVATE COMPANIES a/

	Expressed as Fractions c/ of After-Tax Corporate Income	Expressed as Fractions of Comprehensive Corporate Source Income b/
Case 1: Typical Public Company		
Dividends	.5	.20192
Undistributed corporate income	.5	.20191
Goodwill gains on corporate stock held by the taxpayer	.5	.20192
Corporation tax paid	-	.39425
Total		1.00000
Cases 2 and 3: Typical Private Company		
Dividends	.5	.27957
Undistributed corporate income (section 105 distributions for Case 3)	.5	.27957
Goodwill gains on corporate stock held by the taxpayer	.25	.13978
Corporation tax paid	-	.30108
Total		1.00000

a/ Based on an assumed current average corporation tax rate on before-tax corporate income of 49.4 per cent for a typical public company and 35 per cent for a typical private company. This assumption has regard to the dual rate of corporation tax and the generally larger incomes of public companies.

b/ The exact relationship between the ratio of a particular income component to total comprehensive corporate source income and the ratio of the component to after-tax corporate income may be determined under the formula set out below. Let r be the ratio of after-tax corporate income to total comprehensive corporate source income; let d, g and s be the ratios of dividends, goodwill gains and section 105 capitalizations respectively to after-tax corporate income; let f be the fraction of dividends and section 105 capitalizations carrying credit for corporation tax under our integration proposals; and let c be the average corporation tax rate. Then

$$r = \frac{1 - c}{1 + [1 - c]\,[g + (1 - f)\,(s + d)]}$$

The ratio to comprehensive income of any component expressed as a fraction of after-tax corporate income can be obtained by multiplying that fraction by r.

c/ For a discussion of the assumptions underlying these fractions see Appendix A to Volume 6.

TABLE M-2

CASE 1 EXAMPLE:

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS FOR AN UNATTACHED INDIVIDUAL WITH $10,000 OF COMPREHENSIVE TAX BASE INCOME DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PUBLIC COMPANY a/

	Tax Base and Taxes Under the Current System		Tax Base and Taxes Under the Proposed System	
Tax Base	At Corporate Level b/	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$2,019.15	$2,019.15	$2,019.15	$2,019.15
Other corporate income, before corporation tax	5,961.70 c/	N.A.	5,961.70	5,961.70
Goodwill gains on corporate stock held by taxpayer	-	N.A.	-	2,019.15
Total corporate source base	$7,980.85	$2,019.15	$7,980.85	$10,000.00
Family allowances	-	N.A.	-	-
Total income	$7,980.85	$2,019.15	$7,980.85	$10,000.00 d/
Deductions:				
Family exemptions	-	1,000.00	-	N.A.
Standard deduction	-	100.00	-	50.00
Total deductions	-	$1,100.00	-	$50.00
Net tax base	$7,980.85	$ 919.15	$7,980.85	$9,950.00
Taxes				
Gross tax (before credits)	$3,942.54	$101.11	$3,990.43	$1,942.00
Non-refundable tax credits:				
Credits for dependants	-	N.A.	-	-
Dividend tax credit	-	$403.83	-	N.A.
		$403.83		-
Tax after credits	-	-	-	$1,942.00
Refundable credit on corporation taxes	-	N.A.	-	3,990.43
Personal income tax	-	-	-	($2,048.43)
Old age security tax	-	$ 36.77	-	N.A.
Total tax	$3,942.54	$ 36.77	$3,990.43	($2,048.43)
Total taxes	$3,979.31		$1,942.00	
Undistributed or unallocated income	$2,019.15		-	

a/ Numbers enclosed in parentheses are negative. "N.A." means non-applicable.

b/ The relationship among the components of corporate source income is that specified in Table M-1, column 2, for a typical public company.

c/ Consists of undistributed income of $2,019.15 and corporation tax of $3,942.54 (49.4 per cent of $7,980.85).

d/ This is the income of the taxpayer considered in this example.

TABLE M-3

CASE 2 EXAMPLE:

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS FOR A MARRIED COUPLE WITH TWO CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $8,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 a/

	Tax Base and Taxes Under the Current System		Tax Base and Taxes Under the Proposed System	
Tax Base	At Corporate Level b/	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$2,236.56	$2,236.56	$2,236.56	$2,236.56
Other corporate income, before corporation tax	4,645.16 c/	N.A.	4,645.16	4,645.16
Goodwill gains on corporate stock held by taxpayer	-	N.A.	-	1,118.28
Total corporate source base	$6,881.72	$2,236.56	$6,881.72	$8,000.00 d/
Family allowances	-	N.A.	-	144.00
Total income	$6,881.72	$2,236.56	$6,881.72	$8,144.00
Deductions:				
Family exemptions	-	2,600.00	-	N.A.
Standard deduction	-	100.00	-	50.00
Total deductions	-	$2,700.00	-	$50.00
Net tax base	$6,881.72	-	$6,881.72	$8,094.00
Taxes				
Gross tax (before credits)	$2,408.60	-	$3,440.86	$1,066.74
Non-refundable tax credits:				
Credits for dependants	-	N.A.	-	160.00
Dividend tax credit	-	447.31	-	N.A.
	-	$447.31	-	$160.00
Tax after credits	-	-	-	906.74
Refundable credit on corporation taxes	-	N.A.	-	3,440.86
Personal income tax	-	-	-	($2,534.12)
Old age security tax	-	-	-	N.A.
Total tax	$2,408.60	-	$3,440.86	($2,534.12)
Total taxes	$2,408.60		$906.74	
Undistributed or unallocated income	$2,236.56		-	

a/ Numbers enclosed in parentheses are negative. "N.A." means non-applicable.

b/ The relationship among the components of corporate source income is that specified in Table M-1, column 2, for a typical private company.

c/ Consists of undistributed income of $2,236.56 and corporation tax of $2,408.60 (35 per cent of $6,881.72).

d/ This is the income of the taxpayer considered in this example.

TABLE M-4

CASE 3 EXAMPLE:

CALCULATION OF TAXES UNDER THE CURRENT AND PROPOSED SYSTEMS FOR A MARRIED COUPLE WITH THREE CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $100,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PRIVATE COMPANY CAPITALIZING EARNED SURPLUS UNDER SECTION 105 a/

	Tax Base and Taxes Under the Current System		Tax Base and Taxes Under the Proposed System	
Tax Base	At Corporate Level b/	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$27,956.99	$27,956.99	$27,956.99	$27,956.99
Section 105 distributions	27,956.99	N.A.	27,956.99	27,956.99
Other corporate income, before corporation tax	30,107.53 c/	N.A.	30,107.53	30,107.53
Goodwill gains on stock held by taxpayer	-	N.A.	-	13,978.49
Total corporate source base	$86,021.51	$27,956.99	$86,021.51	$100,000.00 d/
Family allowances	-	N.A.	-	$ 216.00
Total income	$86,021.51	$27,956.99	$86,021.51	$100,216.00
Deductions:				
Family exemptions	-	2,900.00	-	N.A.
Standard deduction	-	100.00	-	50.00
Total deductions	-	$ 3,000.00	-	$ 50.00
Net tax base	$86,021.51	$24,956.99	$86,021.51	$100,166.00
Taxes				
Gross tax (before credits)	$30,107.53	$ 8,530.65	$43,010.76	$38,760.00
Additional tax on section 105 distributions	4,193.55	-	N.A.	-
Non-refundable tax credits:				
Credits for dependants	-	N.A.	-	220.00
Dividend tax credit	-	$ 5,591.40	-	N.A.
		$ 5,591.40		$ 220.00
Tax after credits	-	$ 2,939.25	-	$38,540.00
Refundable credit for corporation taxes	-	N.A.	-	$43,010.76
Personal income tax	-	$ 2,939.25	-	($ 4,470.76)
Old age security tax	-	120.00	-	N.A.
Total tax	$34,301.08	$ 3,059.25	$43,010.76	($ 4,470.76)
Total taxes	$37,360.33		$38,540.00	
Undistributed or unallocated income	-		-	

a/ Numbers enclosed in parentheses are negative. "N.A." means not applicable.

b/ The relationship among the components of corporate source income is that specified in Table M-1, column 2, for a typical private company.

c/ Consists of corporation tax only (35 per cent of $86,021.51).

d/ This is the income of the taxpayer considered in this example.

TABLE M, 1-1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE, NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	591.	591.	591.	591.	591.	591.	591.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-537.	-591.	-591.	-591.	-591.	-591.	-591.
2000	CURRENT TAX (1966 RATES)	789.	789.	789.	789.	789.	789.	789.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-661.	-789.	-789.	-789.	-789.	-789.	-789.
2500	CURRENT TAX (1966 RATES)	986.	986.	986.	986.	986.	986.	986.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-774.	-940.	-986.	-986.	-986.	-986.	-986.
3000	CURRENT TAX (1966 RATES)	1183.	1183.	1183.	1183.	1183.	1183.	1183.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-886.	-1072.	-1162.	-1183.	-1183.	-1183.	-1183.
3500	CURRENT TAX (1966 RATES)	1380.	1380.	1380.	1380.	1380.	1380.	1380.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	-985.	-1191.	-1279.	-1328.	-1376.	-1380.	-1380.
4000	CURRENT TAX (1966 RATES)	1577.	1577.	1577.	1577.	1577.	1577.	1577.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	-1082.	-1308.	-1396.	-1443.	-1490.	-1577.	-1577.
5000	CURRENT TAX (1966 RATES)	1971.	1971.	1971.	1971.	1971.	1971.	1971.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	-1257.	-1523.	-1610.	-1656.	-1703.	-1795.	-1934.
6500	CURRENT TAX (1966 RATES)	2571.	2563.	2563.	2563.	2563.	2563.	2563.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	-1508.	-1826.	-1911.	-1957.	-2002.	-2094.	-2230.
8000	CURRENT TAX (1966 RATES)	3175.	3154.	3154.	3154.	3154.	3154.	3154.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	-1752.	-2117.	-2202.	-2247.	-2292.	-2382.	-2517.
10000	CURRENT TAX (1966 RATES)	3979.	3943.	3943.	3943.	3943.	3943.	3943.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	-2037.	-2486.	-2571.	-2615.	-2659.	-2747.	-2880.
12000	CURRENT TAX (1966 RATES)	4784.	4744.	4732.	4731.	4731.	4731.	4731.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	-2283.	-2848.	-2920.	-2961.	-3004.	-3090.	-3218.
15000	CURRENT TAX (1966 RATES)	5991.	5951.	5939.	5927.	5915.	5914.	5914.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	-2591.	-3336.	-3406.	-3435.	-3463.	-3543.	-3665.
20000	CURRENT TAX (1966 RATES)	8003.	7963.	7951.	7939.	7927.	7903.	7885.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	-3004.	-3999.	-4067.	-4092.	-4118.	-4170.	-4265.
25000	CURRENT TAX (1966 RATES)	9976.	9974.	9962.	9950.	9938.	9914.	9878.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	-3229.	-4463.	-4528.	-4550.	-4573.	-4619.	-4687.
30000	CURRENT TAX (1966 RATES)	11948.	11948.	11948.	11948.	11948.	11926.	11890.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	-3351.	-4688.	-4762.	-4795.	-4828.	-4871.	-4933.
40000	CURRENT TAX (1966 RATES)	15890.	15890.	15890.	15890.	15890.	15890.	15890.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	-3395.	-4832.	-4904.	-4934.	-4963.	-5023.	-5112.
50000	CURRENT TAX (1966 RATES)	19833.	19833.	19833.	19833.	19833.	19833.	19833.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	-3139.	-4577.	-4646.	-4674.	-4703.	-4759.	-4844.
70000	CURRENT TAX (1966 RATES)	28155.	27755.	27718.	27718.	27718.	27718.	27718.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	-2463.	-3501.	-3531.	-3558.	-3584.	-3638.	-3719.
100000	CURRENT TAX (1966 RATES)	41398.	40948.	40813.	40678.	40543.	40273.	39868.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	-1308.	-2296.	-2225.	-2114.	-2003.	-1781.	-1448.
200000	CURRENT TAX (1966 RATES)	86586.	86086.	85936.	85786.	85636.	85336.	84886.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	3504.	2566.	2652.	2778.	2904.	3156.	3534.
350000	CURRENT TAX (1966 RATES)	156767.	156167.	155987.	155807.	155627.	155267.	154727.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	8323.	7485.	7601.	7757.	7913.	8225.	8693.
600000	CURRENT TAX (1966 RATES)	277024.	276374.	276179.	275984.	275789.	275399.	274814.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	13066.	12278.	12409.	12580.	12751.	13093.	13606.
1000000	CURRENT TAX (1966 RATES)	474861.	474161.	473951.	473741.	473531.	473111.	472481.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	15229.	14491.	14637.	14823.	15009.	15381.	15939.

Note: See assumptions in Table M-1.

TABLE M, 1–2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966) RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.358	–0.394	–0.394	–0.394	–0.394	–0.394	–0.394
2000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	–0.394
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.331	–0.394	–0.394	–0.394	–0.394	–0.394	–0.394
2500	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.310	–0.376	–0.394	–0.394	–0.394	–0.394	–0.394
3000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.295	–0.357	–0.387	–0.394	–0.394	–0.394	–0.394
3500	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.281	–0.340	–0.366	–0.379	–0.393	–0.394	–0.394
4000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.271	–0.327	–0.349	–0.361	–0.373	–0.394	–0.394
5000	CURRENT TAX (1966 RATES)	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	–0.251	–0.305	–0.322	–0.331	–0.341	–0.0359	–0.387
6500	CURRENT TAX (1966 RATES)	0.396	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	–0.232	–0.281	–0.294	–0.301	–0.308	–0.322	–0.343
8000	CURRENT TAX (1966 RATES)	0.397	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	–0.219	–0.265	–0.275	–0.281	–0.287	–0.298	–0.315
10000	CURRENT TAX (1966 RATES)	0.398	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	–0.204	–0.249	–0.257	–0.261	–0.266	–0.275	–0.288
12000	CURRENT TAX (1966 RATES)	0.399	0.395	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	–0.190	–0.237	–0.243	–0.247	–0.250	–0.257	–0.268
15000	CURRENT TAX (1966 RATES)	0.399	0.397	0.396	0.395	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	–0.173	–0.222	–0.227	–0.229	–0.231	–0.236	–0.244
20000	CURRENT TAX (1966 RATES)	0.400	0.398	0.398	0.397	0.396	0.395	–0.394
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	–0.150	–0.200	–0.203	–0.205	–0.206	–0.208	–0.213
25000	CURRENT TAX (1966 RATES)	0.399	0.399	0.398	0.398	0.398	0.397	0.395
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	–0.129	–0.179	–0.181	–0.182	–0.183	–0.185	–0.187
30000	CURRENT TAX (1966 RATES)	0.398	0.398	0.398	0.398	0.398	0.398	0.396
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	–0.112	–0.156	–0.159	–0.160	–0.161	–0.162	–0.164
40000	CURRENT TAX (1966 RATES)	0.397	0.397	0.397	0.397	0.397	0.397	0.397
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	–0.085	–0.121	–0.123	–0.123	–0.124	–0.126	–0.128
50000	CURRENT TAX (1966 RATES)	0.397	0.397	0.397	0.397	0.397	0.397	0.397
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	–0.063	–0.092	–0.093	–0.093	–0.094	–0.095	–0.097
70000	CURRENT TAX (1966 RATES)	0.402	0.396	0.396	0.396	0.396	0.396	0.396
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	–0.035	–0.050	–0.050	–0.051	–0.051	–0.052	–0.053
100000	CURRENT TAX (1966 RATES)	0.414	0.409	0.408	0.407	0.405	0.403	0.399
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	–0.013	–0.023	–0.022	–0.021	–0.020	–0.018	–0.014
200000	CURRENT TAX (1966 RATES)	0.433	0.430	0.430	0.429	0.428	0.427	0.424
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.018	0.013	–0.013	0.014	0.015	0.016	0.018
350000	CURRENT TAX (1966 RATES)	0.448	0.446	0.446	0.445	0.445	0.444	0.442
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.024	0.021	0.022	0.022	0.023	0.024	0.025
600000	CURRENT TAX (1966 RATES)	0.462	0.461	0.460	0.460	0.460	0.459	0.458
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.022	0.020	0.021	01021	0.021	0.022	0.023
1000000	CURRENT TAX (1966 RATES)	0.475	0.474	0.474	0.474	0.474	0.473	0.472
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.015	–0.014	0.015	0.015	0.015	0.015	0.016

Note: See assumptions in Table M–1.

TABLE M, 1-3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.252	−0.399	−0.399	−0.399	−0.399	−0.399	−0.399
2000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.231	−0.308	−0.399	−0.399	−0.399	−0.399	−0.399
2500	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.229	−0.269	−0.358	−0.399	−0.399	−0.399	−0.399
3000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.202	−0.242	−0.239	−0.295	−0.392	−0.399	−0.399
3500	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.199	−0.239	−0.238	−0.235	−0.232	−0.399	−0.399
4000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	−0.181	−0.221	−0.219	−0.219	−0.219	−0.233	−0.399
5000	CURRENT TAX (1966 RATES)	0.400	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	−0.171	−0.210	−0.209	−0.209	−0.209	−0.209	−0.209
6500	CURRENT TAX (1966 RATES)	0.407	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	−0.167	−0.199	−0.199	−0.199	−0.199	−0.199	−0.199
8000	CURRENT TAX (1966 RATES)	0.407	0.399	0.399	00.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	−0.149	−0.190	−0.189	−0.189	−0.189	−0.189	−0.189
10000	CURRENT TAX (1966 RATES)	0.407	0.401	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	−0.129	−0.182	−0.179	−0.179	−0.179	−0.179	−0.179
12000	CURRENT TAX (1966 RATES)	0.407	0.407	0.407	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	−0.109	−0.169	−0.167	−0.159	−0.159	−0.159	−0.159
15000	CURRENT TAX (1966 RATES)	0.407	0.407	0.407	0.407	0.407	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	−0.089	−0.140	−0.137	−0.137	−0.137	−0.129	−0.129
20000	CURRENT TAX (1966 RATES)	0.404	0.407	0.407	0.407	0.407	0.407	0.399
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	−0.057	−0.101	−0.097	−0.097	−0.097	−0.097	−0.089
25000	CURRENT TAX (1966 RATES)	0.399	0.403	0.407	0.407	0.407	0.407	0.407
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	−0.031	−0.057	−0.057	−0.057	−0.057	−0.057	−0.057
30000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.407	0.407
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	−0.011	−0.022	−0.019	−0.019	−0.019	−0.027	−0.027
40000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	0.018	0.017	0.021	0.021	0.021	0.021	0.021
50000	CURRENT TAX (1966 RATES)	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	0.039	0.039	0.041	0.041	0.041	0.041	0.041
70000	CURRENT TAX (1966 RATES)	0.439	0.439	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	0.021	0.021	0.061	0.061	0.061	0.061	0.061
100000	CURRENT TAX (1966 RATES)	0.450	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.049	0.049	0.050	0.050	0.050	0.050	0.050
200000	CURRENT TAX (1966 RATES)	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.040	0.040	0.040	0.040	0.040	0.040	0.040
350000	CURRENT TAX (1966 RATES)	0.480	0.480	0.480	0.480	0.480	0.480	0.480
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.020	0.020	0.020	0.020	0.020	0.020	0.020
600000	CURRENT TAX (1966 RATES)	0.490	0.490	0.490	0.490	0.490	0.490	0.490
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.010	0.010	0.010	0.010	0.010	0.010	0.010
1000000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Note: See assumptions in Table M–1.

TABLE M, 2–1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE: NUMBER OF CHILDREN 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	452.	452.	452.	452.	452.	452.	452.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–398.	–452.	–452.	–452.	–452.	–452.	–452.
2000	CURRENT TAX (1966 RATES)	602.	602.	602.	602.	602.	602.	602.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–475.	–602.	–602.	–602.	–602.	–602.	–602.
2500	CURRENT TAX (1966 RATES)	753.	753.	753.	753.	753.	753.	753.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–541.	–707.	–753.	–753.	–753.	–753.	–753.
3000	CURRENT TAX (1966 RATES)	903.	903.	903.	903.	903.	903.	903.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–607.	–793.	–883.	–903.	–903.	–903.	–903.
3500	CURRENT TAX (1966 RATES)	1054.	1054.	1054.	1054.	1054.	1054.	1054.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	–659.	–865.	–953.	–1002.	–1050.	–1054.	–1054.
4000	CURRENT TAX (1966 RATES)	1205.	1204.	1204.	1204.	1204.	1204.	1204.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	–710.	–935.	–1023.	–1070.	–1117.	–1204.	–1204.
5000	CURRENT TAX (1966 RATES)	1517.	1505.	1505.	1505.	1505.	1505.	1505.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	–803.	–1057.	–1144.	–1191.	–1237.	–1329.	–1468.
6500	CURRENT TAX (1966 RATES)	1986.	1957.	1957.	1957.	1957.	1957.	1957.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	–923.	–1220.	–1306.	–1351.	–1397.	–1488.	–1625.
8000	CURRENT TAX (1966 RATES)	2454.	2414.	2409.	2409.	2409.	2409.	2409.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	–1031.	–1377.	–1457.	–1502.	–1547.	–1637.	–1771.
10000	CURRENT TAX (1966 RATES)	3079.	3039.	3027.	3015.	3011.	3011.	3011.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	–1137.	–1582.	–1655.	–1687.	–1727.	–1816.	–1948.
12000	CURRENT TAX (1966 RATES)	3703.	3663.	3651.	3639.	3627.	3613.	3613.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	–1202.	–1767.	–1839.	–1870	–1900.	–1972.	–2100.
15000	CURRENT TAX (1966 RATES)	4636.	4600.	4588.	4576.	4564.	4540.	4516.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	–1236.	–1985.	–2055.	–2083.	–2112.	–2169.	–2267.
20000	CURRENT TAX (1966 RATES)	6142.	6142.	6142.	6137.	6125.	6101.	6065.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	–1143.	–2178.	–2258.	–2291.	–2317.	–2368.	–2445.
25000	CURRENT TAX (1966 RATES)	7647.	7647.	7647.	7647.	7647.	7647.	7626.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	–899.	–2135.	–2212.	–2247.	–2282.	–2351.	–2435.
30000	CURRENT TAX (1966 RATES)	9152.	9152.	9152.	9152.	9152.	9152.	9152.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	–556.	–1893.	–1967.	–2000.	–2032.	–2097.	–2195.
40000	CURRENT TAX (1966 RATES)	12163.	12163.	12163.	12163.	12163.	12163.	12163.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	332.	–1105.	–1177.	–1207.	–1236.	–1296.	–1385.
50000	CURRENT TAX (1966 RATES)	15579.	15186.	15174.	15174.	15174.	15174.	15174.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	1115.	70.	13.	–15.	–44.	–100.	–185.
70000	CURRENT TAX (1966 RATES)	22893.	22443.	22308.	22173.	22038.	21768.	21363.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	2799.	1811.	1879.	1987.	2096.	2312.	2636.
100000	CURRENT TAX (1966 RATES)	34115.	33615.	33465.	33315.	33167.	32897.	32492.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	5976.	5038.	5123.	5249.	5373.	5595.	5928.
200000	CURRENT TAX (1966 RATES)	73350.	72800.	72635.	72470.	72305.	71975.	71480.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	16740.	15852.	15953.	16094.	16235.	16517.	16940.
350000	CURRENT TAX (1966 RATES)	135364.	134714.	134519.	134324.	134129.	133739.	133154.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	29726.	28938.	29069.	29240.	29411.	29753.	30266.
600000	CURRENT TAX (1966 RATES)	244166.	243466.	243256.	243046.	242836.	242416.	241786.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	45924.	45186.	45332.	45518.	45704.	46076.	46634.
1000000	CURRENT TAX (1966 RATES)	423184.	422434.	422209.	421984.	421759.	421309.	420634.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540	488492.	488420.
	INCREASE OR DECREASE IN TAX	66906.	66218.	66379.	66580.	66781.	67183.	67786.

Note: See assumptions in Table M–1.

TABLE M, 2-2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.265	-0.301	-0.301	-0.301	-0.301	-0.301	-0.301
2000	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.237	-0.301	-0.301	-0.301	-0.301	-0.301	-0.301
2500	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.216	-0.283	-0.301	-0.301	-0.301	-0.301	-0.301
3000	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.202	-0.264	-0.294	-0.301	-0.301	-0.301	-0.301
3500	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.188	-0.247	-0.272	-0.286	-0.300	-0.301	-0.301
4000	CURRENT TAX (1966 RATES)	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	-0.178	-0.234	-0.256	-0.268	-0.279	-0.301	-0.301
5000	CURRENT TAX (1966 RATES)	0.303	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	-0.161	-0.211	-0.229	-0.238	-0.247	-0.266	-0.294
6500	CURRENT TAX (1966 RATES)	0.305	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	-0.142	-0.188	-0.201	-0.208	-0.215	-0.229	-0.250
8000	CURRENT TAX (1966 RATES)	0.307	0.302	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	-0.129	-0.172	-0.182	-0.188	-0.193	-0.205	-0.221
10000	CURRENT TAX (1966 RATES)	0.308	0.304	0.303	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	-0.114	-0.158	-0.165	-0.169	-0.173	-0.182	-0.195
12000	CURRENT TAX (1966 RATES)	0.309	0.305	0.304	0.303	0.302	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	-0.100	-0.147	-0.153	-0.156	-0.158	-0.164	-0.175
15000	CURRENT TAX (1966 RATES)	0.309	0.307	0.306	0.305	0.304	0.303	0.301
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	-0.082	-0.132	-0.137	-0.139	-0.141	-0.145	-0.151
20000	CURRENT TAX (1966 RATES)	0.307	0.307	0.307	0.307	0.306	0.305	0.303
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	-0.057	-0.109	-0.113	-0.115	-0.116	-0.118	-0.122
25000	CURRENT TAX (1966 RATES)	0.306	0.306	0.306	0.306	0.306	0.306	0.305
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	-0.036	-0.085	-0.088	-0.090	-0.091	-0.094	-0.097
30000	CURRENT TAX (1966 RATES)	0.305	0.305	0.305	0.305	0.305	0.305	0.305
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	-0.019	-0.063	-0.066	-0.067	-0.068	-0.070	-0.073
40000	CURRENT TAX (1966 RATES)	0.304	0.304	0.304	0.304	0.304	0.304	0.304
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	0.008	-0.028	-0.029	-0.030	-0.031	-0.032	-0.035
50000	CURRENT TAX (1966 RATES)	0.312	0.304	0.303	0.303	0.303	0.303	0.303
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	0.022	0.001	0.000	0.000	-0.001	-0.002	-0.004
70000	CURRENT TAX (1966 RATES)	0.327	0.321	0.319	0.317	0.315	0.311	0.305
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	0.040	0.026	0.027	0.028	0.030	0.033	0.038
100000	CURRENT TAX (1966 RATES)	0.341	0.336	0.335	0.333	0.332	0.329	0.325
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	0.060	0.050	0.051	0.052	0.054	0.056	0.059
200000	CURRENT TAX (1966 RATES)	0.367	0.364	0.363	0.362	0.362	0.360	0.357
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.084	0.079	0.080	0.080	0.081	0.083	0.085
350000	CURRENT TAX (1966 RATES)	0.387	0.385	0.384	0.384	0.383	0.382	0.380
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.085	0.083	0.083	0.084	0.084	0.085	0.086
600000	CURRENT TAX (1966 RATES)	0.407	0.406	0.405	0.405	0.405	0.404	0.403
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.077	0.075	0.076	0.076	0.076	0.077	0.078
1000000	CURRENT TAX (1966 RATES)	0.423	0.422	0.422	0.422	0.422	0.421	0.421
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.067	0.066	0.066	0.067	0.067	0.067	0.068

Note: See assumptions in Table M-1.

TABLE M, 2–3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.283	–0.430	–0.430	–0.430	–0.430	–0.430	–0.430
2000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.262	–0.339	–0.430	–0.430	–0.430	–0.430	–0.430
2500	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.260	–0.300	–0.389	–0.430	–0.430	–0.430	–0.430
3000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.233	–0.273	–0.270	–0.326	–0.423	–0.430	–0.430
3500	CURRENT TAX (1966 RATES)	0.432	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.232	–0.270	–0.269	–0.266	–0.263	–0.430	–0.430
4000	CURRENT TAX (1966 RATES)	0.441	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	–0.223	–0.252	–0.250	–0.250	–0.250	–0.265	–0.430
5000	CURRENT TAX (1966 RATES)	0.441	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	–0.212	–0.241	–0.240	–0.240	–0.240	–0.240	–0.240
6500	CURRENT TAX (1966 RATES)	0.441	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	–0.201	–0.230	–0.230	–0.230	–0.230	–0.230	–0.230
8000	CURRENT TAX (1966 RATES)	0.441	0.441	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	–0.183	–0.232	–0.220	–0.220	–0.220	–0.220	–0.220
10000	CURRENT TAX (1966 RATES)	0.441	0.441	0.441	0.441	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	–0.163	–0.222	–0.221	–0.221	–0.210	–0.210	–0.210
12000	CURRENT TAX (1966 RATES)	0.441	0.441	0.441	0.441	0.441	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	–0.143	–0.203	–0.201	–0.201	–0.201	–0.190	–0.190
15000	CURRENT TAX (1966 RATES)	0.430	0.441	0.441	0.441	0.441	0.441	0.430
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	–0.112	–0.174	–0.171	–0.171	–0.171	–0.171	–0.160
20000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.439	0.441	0.441	0.441
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	–0.083	–0.124	–0.120	–0.129	–0.131	–0.131	–0.131
25000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.441
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	–0.062	–0.084	–0.080	–0.080	–0.080	–0.080	–0.091
30000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	–0.042	–0.053	–0.050	–0.050	–0.050	–0.050	–0.050
40000	CURRENT TAX (1966 RATES)	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	–0.013	–0.014	–0.010	–0.010	–0.010	–0.010	–0.010
50000	CURRENT TAX (1966 RATES)	0.486	0.474	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	–0.048	–0.036	–0.010	–0.010	–0.010	–0.010	–0.010
70000	CURRENT TAX (1966 RATES)	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	–0.040	–0.040	–0.040	–0.040	–0.040	–0.040	–0.040
100000	CURRENT TAX (1966 RATES)	0.514	0.514	0.514	0.514	0.510	0.500	0.500
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.015	–0.015	–0.014	–0.014	–0.010	0.000	0.000
200000	CURRENT TAX (1966 RATES)	0.528	0.528	0.528	0.528	0.528	0.528	0.528
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.028	–0.028	–0.028	–0.028	–0.028	–0.028	–0.028
350000	CURRENT TAX (1966 RATES)	0.556	0.556	0.556	0.556	0.556	0.556	0.556
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.056	–0.056	–0.056	–0.056	–0.056	–0.056	–0.056
600000	CURRENT TAX (1966 RATES)	0.570	0.570	0.570	0.570	0.570	0.570	0.570
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.070	–0.070	–0.070	–0.070	–0.070	–0.070	–0.070
1000000	CURRENT TAX (1966 RATES)	0.584	0.584	0.584	0.584	0.584	0.584	0.584
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	–0.084	–0.084	–0.084	–0.084	–0.084	–0.084	–0.084

Note: See assumptions in Table M–1.

TABLE M, 3-1

CHANGES IN TAX LIABILITIES UNDER THE PROPOSED TAX SYSTEM (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY CAPITALIZING HALF ITS EARNINGS UNDER SECTION 105

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE, NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	515.	515.	515.	515.	515.	515.	515.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-461.	-515.	-515.	-515.	-515.	-515.	-515.
2000	CURRENT TAX (1966 RATES)	686.	686.	686.	686.	686.	686.	686.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-559.	-686.	-686.	-686.	-686.	-686.	-686.
2500	CURRENT TAX (1966 RATES)	858.	858.	858.	858.	858.	858.	858.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-646.	-812.	-858.	-858.	-858.	-858.	-858.
3000	CURRENT TAX (1966 RATES)	1029.	1029.	1029.	1029.	1029.	1029.	1029.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	-733.	-919.	-1009.	-1029.	-1029.	-1029.	-1029.
3500	CURRENT TAX (1966 RATES)	1201.	1201.	1201.	1201.	1201.	1201.	1201.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	-806.	-1012.	-1100.	-1148.	-1197.	-1201.	-1201.
4000	CURRENT TAX (1966 RATES)	1373.	1372.	1372.	1372.	1372.	1372.	1372.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	-878.	-1103.	-1191.	-1238.	-1285.	-1372.	-1372.
5000	CURRENT TAX (1966 RATES)	1727.	1715.	1715.	1715.	1715.	1715.	1715.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	-1013.	-1267.	-1354.	-1400.	-1447.	-1539.	-1678.
6500	CURRENT TAX (1966 RATES)	2258.	2230.	2230.	2230.	2230.	2230.	2230.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	-1195.	-1493.	-1578.	-1624.	-1669.	-1761.	-1897.
8000	CURRENT TAX (1966 RATES)	2790.	2750.	2744.	2744.	2744.	2744.	2744.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	-1367.	-1713.	-1792.	-1837.	-1882.	-1972.	-2107.
10000	CURRENT TAX (1966 RATES)	3498.	3458.	3446.	3434.	3430.	3430.	3430.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	-1556.	-2001.	-2074.	-2106.	-2147.	-2235.	-2367.
12000	CURRENT TAX (1966 RATES)	4206.	4166.	4154.	4142.	4130.	4116.	4116.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	-1705.	-2270.	-2342.	-2373.	-2403.	-2475.	-2603.
15000	CURRENT TAX (1966 RATES)	5265.	5229.	5217.	5205.	5193.	5169.	5145.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	-1865.	-2614.	-2684.	-2713.	-2741.	-2798.	-2896.
20000	CURRENT TAX (1966 RATES)	6980.	6980.	6980.	6976.	6964.	6940.	6904.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	-1981.	-3017.	-3096.	-3130.	-3155.	-3207.	-3284.
25000	CURRENT TAX (1966 RATES)	8695.	8695.	8695.	8695.	8695.	8695.	8675.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	-1948.	-3184.	-3261.	-3295.	-3330.	-3400.	-3484.
30000	CURRENT TAX (1966 RATES)	10410.	10410.	10410.	10410.	10410.	10410.	10410.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	-1814.	-3151.	-3225.	-3258.	-3290.	-3356.	-3453.
40000	CURRENT TAX (1966 RATES)	13840.	13840.	13840.	13840.	13840.	13840.	13840.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	-1345.	-2782.	-2854.	-2884.	-2914.	-2973.	-3063.
50000	CURRENT TAX (1966 RATES)	17676.	17282.	17271.	17271.	17271.	17271.	17271.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	-982.	-2026.	-2084.	-2112.	-2140.	-2197.	-2282.
70000	CURRENT TAX (1966 RATES)	25828.	25378.	25243.	25108.	24973.	24703.	24298.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	-136.	-1124.	-1056.	-948.	-840.	-624.	-299.
100000	CURRENT TAX (1966 RATES)	38308.	37808.	37658.	37508.	37360.	37090.	36685.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	1782.	844.	930.	1056.	1180.	1402.	1735.
200000	CURRENT TAX (1966 RATES)	81737.	81187.	81022.	80857.	80692.	80362.	79867.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	8353.	7465.	7566.	7707.	7848.	8130.	8553.
350000	CURRENT TAX (1966 RATES)	150041.	149391.	149196.	149001.	148806.	148416.	147831.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	15049.	14261.	14392.	14563.	14734.	15076.	15589.
600000	CURRENT TAX (1966 RATES)	269327.	268627.	268417.	268207.	267997.	267577.	266947.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	20763.	20025.	20171.	20357.	20543.	20915.	21473.
1000000	CURRENT TAX (1966 RATES)	465119.	464369.	464144.	463919.	463694.	463244.	462569.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	24971.	24283.	24444.	24645.	24846.	25248.	25851.

Note: See assumptions in Table M-1.

TABLE M, 3–2

EFFECTIVE AVERAGE TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY CAPITALIZING HALF ITS EARNINGS UNDER SECTION 105

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE: NUMBER OF CHILDREN 0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.307	−0.343	−0.343	−0.343	−0.343	−0.343	−0.343
2000	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.279	−0.343	−0.343	−0.343	−0.343	−0.343	−0.343
2500	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.258	−0.325	−0.343	−0.343	−0.343	−0.343	−0.343
3000	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.244	−0.306	−0.336	−0.343	−0.343	−0.343	−0.343
3500	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.230	−0.289	−0.314	−0.328	−0.342	−0.343	−0.343
4000	CURRENT TAX (1966 RATES)	0.343	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	−0.219	−0.276	−0.298	−0.310	−0.321	−0.343	−0.343
5000	CURRENT TAX (1966 RATES)	0.345	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	−0.203	−0.253	−0.271	−0.280	−0.289	−0.308	−0.336
6500	CURRENT TAX (1966 RATES)	0.347	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	−0.184	−0.230	−0.243	−0.250	−0.257	−0.271	−0.292
8000	CURRENT TAX (1966 RATES)	0.349	0.344	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	−0.171	−0.214	−0.224	−0.230	−0.235	−0.246	−0.263
10000	CURRENT TAX (1966 RATES)	0.350	0.346	0.345	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	−0.156	−0.200	−0.207	−0.211	−0.215	−0.223	−0.237
12000	CURRENT TAX (1966 RATES)	0.351	0.347	0.346	0.345	0.344	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	−0.142	−0.189	−0.195	−0.198	−0.200	−0.206	−0.217
15000	CURRENT TAX (1966 RATES)	0.351	0.349	0.348	0.347	0.346	0.345	0.343
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	−0.124	−0.174	−0.179	−0.181	−0.183	−0.187	−0.193
20000	CURRENT TAX (1966 RATES)	0.349	0.349	0.349	0.349	0.348	0.347	0.345
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	−0.099	−0.151	−0.155	−0.156	−0.158	−0.160	−0.164
25000	CURRENT TAX (1966 RATES)	0.348	0.348	0.348	0.348	0.348	0.348	0.347
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	−0.078	−0.127	−0.130	−0.132	−0.133	−0.136	−0.139
30000	CURRENT TAX (1966 RATES)	0.347	0.347	0.347	0.347	0.347	0.347	0.347
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	−0.060	−0.105	−0.107	−0.109	−0.110	−0.112	−0.115
40000	CURRENT TAX (1966 RATES)	0.346	0.346	0.346	0.346	0.346	0.346	0.346
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	−0.034	−0.070	−0.071	−0.072	−0.073	−0.074	−0.077
50000	CURRENT TAX (1966 RATES)	0.354	0.346	0.345	0.345	0.345	0.345	0.345
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	−0.020	−0.041	−0.042	−0.042	−0.043	−0.044	−0.046
70000	CURRENT TAX (1966 RATES)	0.369	0.363	0.361	0.359	0.357	0.353	0.347
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	−0.002	−0.016	−0.015	−0.014	−0.012	−0.009	−0.004
100000	CURRENT TAX (1966 RATES)	0.383	0.378	0.377	0.375	0.374	0.371	0.367
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	0.018	0.008	0.009	0.011	0.012	0.014	0.017
200000	CURRENT TAX (1966 RATES)	0.409	0.406	0.405	0.404	0.403	0.402	0.399
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.042	0.037	0.038	0.039	0.039	0.041	0.043
350000	CURRENT TAX (1966 RATES)	0.429	0.427	0.426	0.426	0.425	0.424	0.422
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.043	0.041	0.041	0.042	0.042	0.043	0.045
600000	CURRENT TAX (1966 RATES)	0.449	0.448	0.447	0.447	0.447	0.446	0.445
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.035	0.033	0.034	0.034	0.034	0.035	0.036
1000000	CURRENT TAX (1966 RATES)	0.465	0.464	0.464	0.464	0.464	0.463	0.463
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.025	0.024	0.024	0.025	0.025	0.025	0.026

Note: See assumptions in Table M–1.

TABLE M, 3–3

EFFECTIVE MARGINAL TAX RATES UNDER THE CURRENT AND PROPOSED TAX SYSTEMS (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY CAPITALIZING HALF ITS EARNINGS UNDER SECTION 105

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.325	−0.472	−0.472	−0.472	−0.472	−0.472	−0.472
2000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.304	−0.381	−0.472	−0.472	−0.472	−0.472	−0.472
2500	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.302	−0.342	−0.431	−0.472	−0.472	−0.472	−0.472
3000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.275	−0.315	−0.312	−0.368	−0.465	−0.472	−0.472
3500	CURRENT TAX (1966 RATES)	0.474	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.274	−0.312	−0.311	−0.308	−0.305	−0.472	−0.472
4000	CURRENT TAX (1966 RATES)	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	−0.265	−0.294	−0.292	−0.292	−0.292	−0.306	−0.472
5000	CURRENT TAX (1966 RATES)	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	−0.254	−0.283	−0.282	−0.282	−0.282	−0.282	−0.282
6500	CURRENT TAX (1966 RATES)	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	−0.243	−0.272	−0.272	−0.272	−0.272	−0.272	−0.272
8000	CURRENT TAX (1966 RATES)	0.483	0.483	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	−0.225	−0.274	−0.262	−0.262	−0.262	−0.262	−0.262
10000	CURRENT TAX (1966 RATES)	0.483	0.483	0.483	0.483	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	−0.205	−0.264	−0.263	−0.263	−0.252	−0.252	−0.252
12000	CURRENT TAX (1966 RATES)	0.483	0.483	0.483	0.483	0.483	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	−0.185	−0.245	−0.243	−0.243	−0.243	−0.232	−0.232
15000	CURRENT TAX (1966 RATES)	0.472	0.483	0.483	0.483	0.483	0.483	0.472
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	−0.154	−0.216	−0.213	−0.213	−0.213	−0.213	−0.202
20000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.481	0.483	0.483	0.483
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	−0.125	−0.166	−0.162	−0.171	−0.173	−0.173	−0.173
25000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.483
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	−0.104	−0.126	−0.122	−0.122	−0.122	−0.122	−0.133
30000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	−0.084	−0.095	−0.092	−0.092	−0.092	−0.092	−0.092
40000	CURRENT TAX (1966 RATES)	0.472	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	−0.055	−0.056	−0.052	−0.052	−0.052	−0.052	−0.052
50000	CURRENT TAX (1966 RATES)	0.528	0.516	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	−0.090	−0.078	−0.032	−0.032	−0.032	−0.032	−0.032
70000	CURRENT TAX (1966 RATES)	0.542	0.542	0.542	0.542	0.542	0.542	0.542
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	−0.082	−0.082	−0.082	−0.082	−0.082	−0.082	−0.082
100000	CURRENT TAX (1966 RATES)	0.556	0.556	0.556	0.556	0.552	0.542	0.542
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.057	−0.057	−0.056	−0.056	−0.052	−0.042	−0.042
200000	CURRENT TAX (1966 RATES)	0.570	0.570	0.570	0.570	0.570	0.570	0.570
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.070	−0.070	−0.070	−0.070	−0.070	−0.070	−0.070
350000	CURRENT TAX (1966 RATES)	0.598	0.598	0.598	0.598	0.598	0.598	0.598
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.098	−0.098	−0.098	−0.098	−0.098	−0.098	−0.098
600000	CURRENT TAX (1966 RATES)	0.612	0.612	0.612	0.612	0.612	0.612	0.612
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.112	−0.112	−0.112	−0.112	−0.112	−0.112	−0.112
1000000	CURRENT TAX (1966 RATES)	0.626	0.626	0.626	0.626	0.626	0.626	0.626
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.126	−0.126	−0.126	−0.126	−0.126	−0.126	−0.126

Note: See assumptions in Table M–1.

APPENDIX N

COMPARISONS OF TAX LIABILITIES ON CORPORATE SOURCE INCOME FROM SHARES FOR TAX UNITS AT DIFFERENT INCOME LEVELS AND WITH DIFFERENT FAMILY CHARACTERISTICS UNDER OUR PROPOSALS AND UNDER THE PROPOSALS OF THE COMMITTEE OF FOUR AS MODIFIED

This appendix provides comparisons of corporation and personal income taxes payable by, or attributable to, tax units with income only from shares under our proposals and under the proposals of the Committee of Four as discussed and modified in Chapter 19. 1/ The comparisons presented show the differences between the total taxes payable under each proposed method of taxation by taxpayers with income only from corporate shares. Differences in average and marginal rates of tax are also shown.

Two comparisons are made:

Case 1: A typical public company distributing one half of its after-tax income as dividends. This corresponds to Case 1 in Appendix M. The results can be found in Tables N, 1-1, N, 1-2 and N, 1-3 provided in this appendix.

Case 2: A typical private company distributing one half of its after-tax income as dividends. This corresponds to Case 2 in Appendix M. The results can be found in Tables N, 2-1, N, 2-2 and N, 2-3 provided in this appendix.

In each case the composition of income is the same as that assumed in the comparable cases in Appendix M, as specified in Table M-1 of that appendix.

The tables are calculated in the same manner as are the tables presented in Appendix M. The figures entered for our proposals in this appendix are in fact identical with those presented in the corresponding tables provided in Appendix M.

The method by which total taxes are computed under each system of taxation is shown in two examples. Table N-1 shows the way in which total

taxes are calculated for a family with two children with a comprehensive tax base income of $10,000 derived exclusively from corporate shares of a typical public company. The taxes derived through this calculation are shown in the fourth column of Table N, 1-1 in the row for a gross corporate source income of $10,000. Table N-2 presents the corresponding tax calculations for a family with two children with a comprehensive tax base income of $100,000 derived exclusively from a typical private company. The resultant taxes are shown in the fourth column of Table N, 2-1 in the row for a gross corporate source income of $100,000.

Under the modified Committee-of-Four proposals the 15 per cent tax would not apply to all corporate income but only to distributions or capitalizations. In all of the calculations we have assumed the same level of distributions as in Appendix M (one half of corporate after-tax income distributed). However, if the modified Committee-of-Four proposals were adopted distributions probably would increase. Most shareholders would prefer to have the corporate income distributed so as to reduce their share gains, which would be subject to tax at higher rates for shareholders with lower income who would be entitled to refunds of the 15 per cent tax and shareholders with marginal tax rates of over 30 per cent. The distribution or capitalization of the remaining balance would increase the figures shown for total taxes by 15 per cent of the amount shown as undistributed income at the bottom of each example given in Tables N-1 and N-2.

In the calculations under the modified Committee-of-Four proposals we have used the same rates of personal income tax for family units and the same credits as under our proposals. We have also assumed the same treatment of family allowances and the same standard deduction as under our proposals. The corporation tax is computed under the dual rate presently in effect, using the average corporation tax rates referred to in note a/ to Table M-1 in Appendix M.

REFERENCE

1/ The principal modification is to bring into a shareholder's income the gains on realization of shares and to apply tax to such gains at one half of personal rates.

TABLE N-1

CASE 1 EXAMPLE:

CALCULATION OF TAXES UNDER OUR PROPOSALS AND THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR FOR A MARRIED COUPLE WITH TWO CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $10,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PUBLIC COMPANY a/

	Tax Base and Taxes Under Our Proposals		Tax Base and Taxes Under Committee-of-Four Proposals	
Tax Base	At Corporate Level	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$2,019.15	$2,019.15	$2,019.15	N.A.
Other corporate income, before corporation tax	5,961.70	5,961.70	5,961.70 b/	N.A.
Goodwill gains on stock held by taxpayer	-	2,019.15	-	2,019.15
Total corporate source base	$7,980.85	$10,000.00 c/	$7,980.85	$2,019.15
Family allowances	-	144.00	-	144.00
Total income	-	$10,144.00	-	$2,163.15
Standard deduction	-	50.00	-	50.00
Net tax base	$7,980.85	$10,094.00	$7,980.85	$2,113.15
Taxes				
Gross tax (before credits)	3,990.43	1,487.68	3,942.54	-
Additional tax on corporate distributions d/	N.A.	-	302.87	-
Non-refundable tax credits for dependants	-	160.00	-	160.00
Tax after dependant credits	-	$1,327.68	-	-
Refundable credits:				
of corporation taxes	-	3,990.43	-	N.A.
on corporate distributions	-	N.A.	-	302.87
Total tax	$3,990.43	($2,662.75)	$4,245.41	($ 302.87)
Total taxes e/	$1,327.68		$3,942.54	
Undistributed or unallocated income	-		$2,019.15	

a/ Numbers enclosed in parentheses are negative. "N.A." means not applicable. The relationship among the components of corporate source income is that specified in Appendix M, Table M-1, column 2, for a shareholder in a typical public company.

b/ Consists of undistributed income of $2,019.15 and corporation tax of $3,942.54 (49.4 per cent of $7,980.85).

c/ This is the income of the taxpayer considered in this example.

d/ 15 per cent of $2,019.15.

e/ Under the modified Committee-of-Four proposals it is possible that the corporation would distribute or capitalize the full amount of corporate income, to reduce to a minimum the amount that would eventually be subject to the capital gains tax. In this example, however, there would be no increase in the total tax payable as the shareholder would receive a refund of the 15 per cent tax paid.

TABLE N-2

CASE 2 EXAMPLE:

CALCULATION OF TAXES UNDER OUR PROPOSALS AND THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR FOR A MARRIED COUPLE WITH TWO CHILDREN WITH A COMPREHENSIVE TAX BASE INCOME OF $100,000 DERIVED EXCLUSIVELY FROM SHARES IN A TYPICAL PRIVATE COMPANY a/

	Tax Base and Taxes Under Our Proposals		Tax Base and Taxes Under Committee-of-Four Proposals	
Tax Base	At Corporate Level	At Personal Level	At Corporate Level	At Personal Level
Income from corporate sources:				
Dividends	$27,956.99	$27,956.99	$27,956.99	N.A.
Other corporate income, before corporation tax	58,064.52	58,064.52	58,064.52 b/	N.A.
Goodwill gains on stock held by taxpayer	-	13,978.49	-	13,978.49
Total corporate source base	$86,021.51	$100,000.00 c/	$86,021.51	$13,978.49
Family allowances	-	144.00	-	144.00
Total income	-	$100,144.00	-	$14,122.49
Standard deduction	-	50.00	-	50.00
Net tax base	$86,021.51	$100,094.00	$86,021.51	$14,072.49
Taxes				
Gross tax (before credits)	$43,010.76	$38,724.00	$30,107.53	$ 863.65
Additional tax on corporate distributions d/	N.A.	-	4,193.55	-
Non-refundable tax credits for dependants	-	160.00	-	160.00
Tax after dependant credits	-	$38,564.00	-	$ 703.65
Refundable credits:				
of corporation taxes	-	$43,010.76	-	N.A.
on corporate distributions	-	N.A.	-	-
Total tax	$43,010.76	($4,446.76)	$34,301.08	$ 703.65
Total taxes e/	$38,564.00		$35,004.73	
Undistributed or unallocated income	-		$27,956.99	

a/ Numbers enclosed in parentheses are negative. "N.A." means not applicable. The relationship among the components of corporate source income is that specified in Appendix M, Table M-1, column 2, for a shareholder in a typical private company.

b/ Consists of undistributed income of $27,956.99 and corporation tax of $30,107.53 (35 per cent of $86,021.51).

c/ This is the income of the taxpayer considered in this example.

d/ 15 per cent of $27,956.99.

e/ Under the modified Committee-of-Four proposals it is possible that the corporation would distribute or capitalize the full amount of corporate income, to reduce to a minimum the amount that would eventually be subject to the capital gains tax. If the 15 per cent were paid on the full corporate income the $35,004.73 of tax would increase to $39,198.28.

TABLE N, 1–1

CHANGES IN TAX LIABILITIES UNDER OUR PROPOSALS FROM THOSE WHICH WOULD ARISE UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	591.	591.	591.	591.	591.	591.	591.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–537.	–591.	–591.	–591.	–591.	–591.	–591.
2000	ALTERNATIVE TAX PROPOSAL	789.	789.	789.	789.	789.	789.	789.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–661.	–789.	–789.	–789.	–789.	–789.	–789.
2500	ALTERNATIVE TAX PROPOSAL	986.	986.	986.	986.	986.	986.	986.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–774.	–940.	–986.	–986.	–986.	–986.	–986.
3000	ALTERNATIVE TAX PROPOSAL	1183.	1183.	1183.	1183.	1183.	1183.	1183.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–886.	–1072.	–1162.	–1183.	–1183.	–1183.	–1183.
3500	ALTERNATIVE TAX PROPOSAL	1380.	1380.	1380.	1380.	1380.	1380.	1380.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	–985.	–1191.	–1279.	–1328.	–1376.	–1380.	–1380.
4000	ALTERNATIVE TAX PROPOSAL	1577.	1577.	1577.	1577.	1577.	1577.	1577.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	–1082.	–1308.	–1396.	–1443.	–1490.	–1577.	–1577.
5000	ALTERNATIVE TAX PROPOSAL	1971.	1971.	1971.	1971.	1971.	1971.	1971.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	–1257.	–1523.	–1610.	–1656.	–1703.	–1795.	–1934.
6500	ALTERNATIVE TAX PROPOSAL	2563.	2563.	2563.	2563.	2563.	2563.	2563.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	–1500.	–1826.	–1911.	–1957.	–2002.	–2094.	–2230.
8000	ALTERNATIVE TAX PROPOSAL	3154.	3154.	3154.	3154.	3154.	3154.	3154.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	–1731.	–2117.	–2202.	–2247.	–2292.	–2382.	–2517.
10000	ALTERNATIVE TAX PROPOSAL	3943.	3943.	3943.	3943.	3943.	3943.	3943.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	–2001.	–2486.	–2571.	–2615.	–2659.	–2747.	–2880.
12000	ALTERNATIVE TAX PROPOSAL	4750.	4731.	4731.	4731.	4731.	4731.	4731.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	–2249.	–2835.	–2919.	–2961.	–3004.	–3090.	–3218.
15000	ALTERNATIVE TAX PROPOSAL	5970.	5914.	5914.	5914.	5914.	5914.	5914.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	–2570.	–3299.	–3381.	–3421.	–3462.	–3543.	–3665.
20000	ALTERNATIVE TAX PROPOSAL	8015.	7885.	7885.	7885.	7885.	7885.	7885.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	–3016.	–3922.	–4001.	–4039.	–4077.	–4152.	–4265.
25000	ALTERNATIVE TAX PROPOSAL	10829.	10662.	10614.	10614.	10614.	10614.	10614.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	–4082.	–5151.	–5179.	–5214.	–5248.	–5318.	–5422.
30000	ALTERNATIVE TAX PROPOSAL	13038.	12850.	12761.	12736.	12736.	12736.	12736.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	–4441.	–5591.	–5576.	–5584.	–5616.	–5681.	–5779.
40000	ALTERNATIVE TAX PROPOSAL	17484.	17257.	17169.	17122.	17075.	16982.	16982.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	–4989.	–6199.	–6183.	–6166.	–6149.	–6114.	–6204.
50000	ALTERNATIVE TAX PROPOSAL	21952.	21684.	21597.	21551.	21505.	21412.	21273.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	–5258.	–6428.	–6411.	–6393.	–6375.	–6339.	–6285.
70000	ALTERNATIVE TAX PROPOSAL	30917.	30568.	30483.	30437.	30391.	30300.	30163.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	–5225.	–6314.	–6296.	–6277.	–6258.	–6221.	–6165.
100000	ALTERNATIVE TAX PROPOSAL	44422.	43931.	43847.	43803.	43759.	43670.	43538.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	–4331.	–5279.	–5259.	–5239.	–5219.	–5178.	–5118.
200000	ALTERNATIVE TAX PROPOSAL	89973.	88929.	88851.	88814.	88776.	88701.	88588.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	117.	–277.	–263.	–250.	–236.	–209.	–168.
350000	ALTERNATIVE TAX PROPOSAL	159266.	157875.	157802.	157769.	157737.	157672.	157574.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163492.	163420.
	INCREASE OR DECREASE IN TAX	5824.	5777.	5786.	5795.	5803.	5820.	5846.
600000	ALTERNATIVE TAX PROPOSAL	276081.	274643.	274576.	274549.	274522.	274469.	274388.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	14009.	14009.	14012.	14015.	14018.	14023.	14032.
1000000	ALTERNATIVE TAX PROPOSAL	465110.	463672.	463608.	463584.	463560.	463512.	463440.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	24980.	24980.	24980.	24980.	24980.	24980.	24980.

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 1–2

EFFECTIVE AVERAGE TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	STATUS OF TAXPAYER: MARRIED COUPLE					
			NUMBER OF CHILDREN					
		0	0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.358	–0.394	–0.394	–0.394	–0.394	–0.394	–0.394
2000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.331	–0.394	–0.394	–0.394	–0.394	–0.394	–0.394
2500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.310	–0.376	–0.394	–0.394	–0.394	–0.394	–0.394
3000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.295	–0.357	–0.387	–0.394	–0.394	–0.394	–0.394
3500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.281	–0.340	–0.366	–0.379	–0.393	–0.394	–0.394
4000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.271	–0.327	–0.349	–0.361	–0.373	–0.394	–0.394
5000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	–0.251	–0.305	–0.322	–0.331	–0.341	–0.359	–0.387
6500	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	–0.231	–0.281	–0.294	–0.301	–0.308	–0.322	–0.343
8000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	–0.216	–0.265	–0.275	–0.281	–0.287	–0.298	–0.315
10000	ALTERNATIVE TAX PROPOSAL	0.394	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	–0.200	–0.249	–0.257	–0.261	–0.266	–0.275	–0.288
12000	ALTERNATIVE TAX PROPOSAL	0.396	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	–0.187	–0.236	–0.243	–0.247	–0.250	–0.257	–0.268
15000	ALTERNATIVE TAX PROPOSAL	0.398	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	–0.171	–0.220	–0.225	–0.228	–0.231	–0.236	–0.244
20000	ALTERNATIVE TAX PROPOSAL	0.401	0.394	0.394	0.394	0.394	0.394	0.394
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	–0.151	–0.196	–0.200	–0.202	–0.204	–0.208	–0.213
25000	ALTERNATIVE TAX PROPOSAL	0.433	0.426	0.425	0.425	0.425	0.425	0.425
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	–0.163	–0.206	–0.207	–0.209	–0.210	–0.213	–0.217
30000	ALTERNATIVE TAX PROPOSAL	0.435	0.428	0.425	0.425	0.425	0.425	0.425
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	–0.148	–0.186	–0.186	–0.186	–0.187	–0.189	–0.193
40000	ALTERNATIVE TAX PROPOSAL	0.437	0.431	0.429	0.428	0.427	0.425	0.425
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	–0.125	–0.155	–0.155	–0.154	–0.154	–0.153	–0.155
50000	ALTERNATIVE TAX PROPOSAL	0.439	0.434	0.432	0.431	0.430	0.428	0.425
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	–0.105	–0.129	–0.128	–0.128	–0.127	–0.127	–0.126
70000	ALTERNATIVE TAX PROPOSAL	0.442	0.437	0.435	0.435	0.434	0.433	0.431
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	–0.075	–0.090	–0.090	–0.090	–0.089	–0.089	–0.088
100000	ALTERNATIVE TAX PROPOSAL	0.444	0.439	0.438	0.438	0.438	0.437	0.435
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	–0.043	–0.053	–0.053	–0.052	–0.052	–0.052	–0.051
200000	ALTERNATIVE TAX PROPOSAL	0.450	0.445	0.444	0.444	0.444	0.444	0.443
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.000	–0.001	–0.001	–0.001	–0.001	–0.001	–0.001
350000	ALTERNATIVE TAX PROPOSAL	0.455	0.451	0.451	0.451	0.451	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.017	0.017	0.017	0.017	0.017	0.017	0.017
600000	ALTERNATIVE TAX PROPOSAL	0.460	0.458	0.458	0.458	0.458	0.457	0.457
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.023	0.023	0.023	0.023	0.023	0.023	0.023
1000000	ALTERNATIVE TAX PROPOSAL	0.465	0.464	0.464	0.464	0.464	0.464	0.463
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.025	0.025	0.025	0.025	0.025	0.025	0.025

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 1–3

EFFECTIVE MARGINAL TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PUBLIC COMPANY

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.252	–0.399	–0.399	–0.399	–0.399	–0.399	–0.399
2000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.231	–0.308	–0.399	–0.399	–0.399	–0.399	–0.399
2500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.229	–0.269	–0.358	–0.399	–0.399	–0.399	–0.399
3000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.202	–0.242	–0.239	–0.295	–0.392	–0.399	–0.399
3500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	–0.199	–0.239	–0.238	–0.235	–0.232	–0.399	–0.399
4000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	–0.181	–0.221	–0.219	–0.219	–0.219	–0.233	–0.399
5000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	–0.170	–0.210	–0.209	–0.209	–0.209	–0.209	–0.209
6500	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	–0.159	–0.199	–0.199	–0.199	–0.199	–0.199	–0.199
8000	ALTERNATIVE TAX PROPOSAL	0.399	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	–0.141	–0.190	–0.189	–0.189	–0.189	–0.189	–0.189
10000	ALTERNATIVE TAX PROPOSAL	0.401	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	–0.123	–0.180	–0.179	–0.179	–0.179	–0.179	–0.179
12000	ALTERNATIVE TAX PROPOSAL	0.411	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	–0.113	–0.161	–0.159	–0.159	–0.159	–0.159	–0.159
15000	ALTERNATIVE TAX PROPOSAL	0.412	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	–0.094	–0.132	–0.129	–0.129	–0.129	–0.129	–0.129
20000	ALTERNATIVE TAX PROPOSAL	0.415	0.399	0.399	0.399	0.399	0.399	0.399
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	–0.068	–0.093	–0.089	–0.089	–0.089	–0.089	–0.089
25000	ALTERNATIVE TAX PROPOSAL	0.446	0.442	0.429	0.429	0.429	0.429	0.429
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	–0.078	–0.096	–0.079	–0.079	–0.079	–0.079	–0.079
30000	ALTERNATIVE TAX PROPOSAL	0.448	0.444	0.445	0.429	0.429	0.429	0.429
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	–0.060	–0.067	–0.065	–0.049	–0.049	–0.049	–0.049
40000	ALTERNATIVE TAX PROPOSAL	0.451	0.447	0.448	0.448	0.448	0.447	0.429
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	–0.034	–0.031	–0.028	–0.028	–0.028	–0.027	–0.009
50000	ALTERNATIVE TAX PROPOSAL	0.453	0.448	0.449	0.449	0.449	0.449	0.449
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	–0.015	–0.010	–0.009	–0.009	–0.009	–0.009	–0.009
70000	ALTERNATIVE TAX PROPOSAL	0.454	0.450	0.450	0.450	0.450	0.450	0.450
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	0.006	0.010	0.010	0.010	0.010	0.010	0.010
100000	ALTERNATIVE TAX PROPOSAL	0.458	0.452	0.452	0.452	0.452	0.452	0.452
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.041	0.047	0.048	0.048	0.048	0.048	0.048
200000	ALTERNATIVE TAX PROPOSAL	0.465	0.461	0.461	0.461	0.461	0.461	0.461
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.035	0.039	0.039	0.039	0.039	0.039	0.039
350000	ALTERNATIVE TAX PROPOSAL	0.469	0.468	0.468	0.468	0.468	0.468	0.468
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.031	0.032	0.032	0.032	0.032	0.032	0.032
600000	ALTERNATIVE TAX PROPOSAL	0.476	0.476	0.476	0.476	0.476	0.476	0.476
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.024	0.024	0.024	0.024	0.024	0.024	0.024
1000000	ALTERNATIVE TAX PROPOSAL	0.480	0.480	0.480	0.480	0.480	0.480	0.480
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.020	0.020	0.020	0.020	0.020	0.020	0.020

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 2–1

CHANGES IN TAX LIABILITIES UNDER OUR PROPOSALS FROM THOSE WHICH WOULD ARISE UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER: UNATTACHED INDIVIDUAL	MARRIED COUPLE — NUMBER OF CHILDREN: 0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	452.	452.	452.	452.	452.	452.	452.
	TAX UNDER OUR PROPOSALS	54.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–398.	–452.	–452.	–452.	–452.	–452.	–452.
2000	ALTERNATIVE TAX PROPOSAL	602.	602.	602.	602.	602.	602.	602.
	TAX UNDER OUR PROPOSALS	128.	0.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–475.	–602.	–602.	–602.	–602.	–602.	–602.
2500	ALTERNATIVE TAX PROPOSAL	753.	753.	753.	753.	753.	753.	753.
	TAX UNDER OUR PROPOSALS	212.	46.	0.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–541.	–707.	–753.	–753.	–753.	–753.	–753.
3000	ALTERNATIVE TAX PROPOSAL	903.	903.	903.	903.	903.	903.	903.
	TAX UNDER OUR PROPOSALS	297.	111.	21.	0.	0.	0.	0.
	INCREASE OR DECREASE IN TAX	–607.	–793.	–883.	–903.	–903.	–903.	–903.
3500	ALTERNATIVE TAX PROPOSAL	1054.	1054.	1054.	1054.	1054.	1054.	1054.
	TAX UNDER OUR PROPOSALS	395.	189.	101.	52.	4.	0.	0.
	INCREASE OR DECREASE IN TAX	–659.	–865.	–953.	–1002.	–1050.	–1054.	–1054.
4000	ALTERNATIVE TAX PROPOSAL	1204.	1204.	1204.	1204.	1204.	1204.	1204.
	TAX UNDER OUR PROPOSALS	495.	269.	181.	134.	87.	0.	0.
	INCREASE OR DECREASE IN TAX	–709.	–935.	–1023.	–1070.	–1117.	–1204.	–1204.
5000	ALTERNATIVE TAX PROPOSAL	1505.	1505.	1505.	1505.	1505.	1505.	1505.
	TAX UNDER OUR PROPOSALS	714.	448.	361.	315.	269.	176.	37.
	INCREASE OR DECREASE IN TAX	–791.	–1057.	–1144.	–1191.	–1237.	–1329.	–1468.
6500	ALTERNATIVE TAX PROPOSAL	1957.	1957.	1957.	1957.	1957.	1957.	1957.
	TAX UNDER OUR PROPOSALS	1063.	737.	651.	606.	560.	469.	332.
	INCREASE OR DECREASE IN TAX	–894.	–1220.	–1306.	–1351.	–1397.	–1488.	–1625.
8000	ALTERNATIVE TAX PROPOSAL	2409.	2409.	2409.	2409.	2409.	2409.	2409.
	TAX UNDER OUR PROPOSALS	1423.	1037.	952.	907.	862.	772.	637.
	INCREASE OR DECREASE IN TAX	–986.	–1372.	–1457.	–1502.	–1547.	–1637.	–1771.
10000	ALTERNATIVE TAX PROPOSAL	3011.	3011.	3011.	3011.	3011.	3011.	3011.
	TAX UNDER OUR PROPOSALS	1942.	1457.	1372.	1328.	1284.	1195.	1063.
	INCREASE OR DECREASE IN TAX	–1069.	–1554.	–1639.	–1683.	–1727.	–1816.	–1948.
12000	ALTERNATIVE TAX PROPOSAL	3613.	3613.	3613.	3613.	3613.	3613.	3613.
	TAX UNDER OUR PROPOSALS	2501.	1896.	1812.	1770.	1727.	1641.	1513.
	INCREASE OR DECREASE IN TAX	–1112.	–1717.	–1801.	–1843.	–1886.	–1972.	–2100.
15000	ALTERNATIVE TAX PROPOSAL	4516.	4516.	4516.	4516.	4516.	4516.	4516.
	TAX UNDER OUR PROPOSALS	3400.	2615.	2533.	2492.	2452.	2371.	2249.
	INCREASE OR DECREASE IN TAX	–1116.	–1901.	–1983.	–2024.	–2064.	–2145.	–2267.
20000	ALTERNATIVE TAX PROPOSAL	6063.	6022.	6022.	6022.	6022.	6022.	6022.
	TAX UNDER OUR PROPOSALS	4999.	3964.	3884.	3846.	3808.	3733.	3620.
	INCREASE OR DECREASE IN TAX	–1064.	–2058.	–2138.	–2175.	–2213.	–2288.	–2401.
25000	ALTERNATIVE TAX PROPOSAL	8665.	8575.	8575.	8575.	8575.	8575.	8575.
	TAX UNDER OUR PROPOSALS	6748.	5512.	5435.	5400.	5365.	5296.	5191.
	INCREASE OR DECREASE IN TAX	–1917.	–3064.	–3141.	–3175.	–3210.	–3280.	–3384.
30000	ALTERNATIVE TAX PROPOSAL	10433.	10290.	10290.	10290.	10290.	10290.	10290.
	TAX UNDER OUR PROPOSALS	8597.	7260.	7185.	7153.	7120.	7055.	6957.
	INCREASE OR DECREASE IN TAX	–1837.	–3031.	–3105.	–3138.	–3170.	–3236.	–3333.
40000	ALTERNATIVE TAX PROPOSAL	13982.	13804.	13720.	13720.	13720.	13720.	13720.
	TAX UNDER OUR PROPOSALS	12496.	11058.	10986.	10956.	10927.	10867.	10778.
	INCREASE OR DECREASE IN TAX	–1487.	–2746.	–2734.	–2764.	–2794.	–2853.	–2943.
50000	ALTERNATIVE TAX PROPOSAL	17544.	17339.	17250.	17202.	17153.	17151.	17151.
	TAX UNDER OUR PROPOSALS	16694.	15256.	15187.	15158.	15130.	15073.	14988.
	INCREASE OR DECREASE IN TAX	–850.	–2083.	–2064.	–2043.	–2023.	–2077.	–2162.
70000	ALTERNATIVE TAX PROPOSAL	24701.	24439.	24352.	24305.	24259.	24166.	24027.
	TAX UNDER OUR PROPOSALS	25692.	24254.	24187.	24160.	24133.	24080.	23999.
	INCREASE OR DECREASE IN TAX	991.	–185.	–165.	–145.	–126.	–87.	–28.
100000	ALTERNATIVE TAX PROPOSAL	35481.	35136.	35050.	35005.	34959.	34868.	34731.
	TAX UNDER OUR PROPOSALS	40091.	38653.	38588.	38564.	38540.	38492.	38420.
	INCREASE OR DECREASE IN TAX	4609.	3517.	3538.	3559.	3581.	3624.	3689.
200000	ALTERNATIVE TAX PROPOSAL	71696.	70972.	70889.	70847.	70804.	70718.	70590.
	TAX UNDER OUR PROPOSALS	90090.	88652.	88588.	88564.	88540.	88492.	88420.
	INCREASE OR DECREASE IN TAX	18394.	17680.	17699.	17717.	17736.	17774.	17830.
350000	ALTERNATIVE TAX PROPOSAL	126613.	125399.	125321.	125283.	125246.	125170.	125057.
	TAX UNDER OUR PROPOSALS	165090.	163652.	163588.	163564.	163540.	163493.	163420.
	INCREASE OR DECREASE IN TAX	38477.	38253.	38267.	38281.	38294.	163492.	38363.
600000	ALTERNATIVE TAX PROPOSAL	219113.	217675.	217606.	217576.	217546.	217487.	217397.
	TAX UNDER OUR PROPOSALS	290090.	288652.	288588.	288564.	288540.	288492.	288420.
	INCREASE OR DECREASE IN TAX	70977.	70977.	70982.	70988.	70994.	71005.	71023.
1000000	ALTERNATIVE TAX PROPOSAL	368653.	367215.	367148.	367122.	367095.	367041.	366960.
	TAX UNDER OUR PROPOSALS	490090.	488652.	488588.	488564.	488540.	488492.	488420.
	INCREASE OR DECREASE IN TAX	121437.	121437.	121440.	121442.	121445.	121451.	121460.

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 2–2

EFFECTIVE AVERAGE TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.036	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.265	–0.301	–0.301	–0.301	–0.301	–0.301	–0.301
2000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.064	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.237	–0.301	–0.301	–0.301	–0.301	–0.301	–0.301
2500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.085	0.018	0.000	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.216	–0.283	–0.301	–0.301	–0.301	–0.301	–0.301
3000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.099	0.037	0.007	0.000	0.000	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.202	–0.264	–0.294	–0.301	–0.301	–0.301	–0.301
3500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.113	0.054	0.029	0.015	0.001	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.188	–0.247	–0.272	–0.286	–0.300	–0.301	–0.301
4000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.124	0.067	0.045	0.033	0.022	0.000	0.000
	CHANGE IN EFFECTIVE RATE	–0.177	–0.234	–0.256	–0.268	–0.279	–0.301	–0.301
5000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	00.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.143	0.090	0.072	0.063	0.054	0.035	0.007
	CHANGE IN EFFECTIVE RATE	–0.158	–0.211	–0.229	–0.238	–0.247	0.266	–0.294
6500	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.164	0.113	0.100	0.093	0.086	0.072	0.051
	CHANGE IN EFFECTIVE RATE	–0.138	–0.188	–0.201	–0.208	–0.215	–0.229	–0.250
8000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.178	0.130	0.119	0.113	0.108	0.097	0.080
	CHANGE IN EFFECTIVE RATE	–0.123	–0.171	–0.182	–0.188	–0.193	–0.205	–0.221
10000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.194	0.146	0.137	0.133	0.128	0.120	0.106
	CHANGE IN EFFECTIVE RATE	–0.107	–0.155	–0.164	–0.168	–0.173	–0.182	–0.195
12000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.208	0.158	0.151	0.147	0.144	0.137	0.126
	CHANGE IN EFFECTIVE RATE	–0.093	–0.143	–0.150	–0.154	–0.157	–0.164	–0.175
15000	ALTERNATIVE TAX PROPOSAL	0.301	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.227	0.174	0.169	0.166	0.163	0.158	0.150
	CHANGE IN EFFECTIVE RATE	–0.074	–0.127	–0.132	–0.135	–0.138	–0.143	–0.151
20000	ALTERNATIVE TAX PROPOSAL	0.303	0.301	0.301	0.301	0.301	0.301	0.301
	TAX UNDER OUR PROPOSALS	0.250	0.198	0.194	0.192	0.190	0.187	0.181
	CHANGE IN EFFECTIVE RATE	–0.053	–0.103	–0.107	–0.109	–0.111	–0.114	–0.120
25000	ALTERNATIVE TAX PROPOSAL	0.347	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.270	0.220	0.217	0.216	0.215	0.212	0.208
	CHANGE IN EFFECTIVE RATE	–0.077	–0.123	–0.126	–0.127	–0.128	–0.131	–0.135
30000	ALTERNATIVE TAX PROPOSAL	0.348	0.343	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.287	0.242	0.240	0.238	0.237	0.235	0.232
	CHANGE IN EFFECTIVE RATE	–0.061	–0.101	–0.103	–0.105	–0.106	–0.108	–0.111
40000	ALTERNATIVE TAX PROPOSAL	0.350	0.345	0.343	0.343	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.312	0.276	0.275	0.274	0.273	0.272	0.269
	CHANGE IN EFFECTIVE RATE	–0.037	–0.069	–0.068	–0.069	–0.070	–0.071	–0.074
50000	ALTERNATIVE TAX PROPOSAL	0.351	0.347	0.345	0.344	0.343	0.343	0.343
	TAX UNDER OUR PROPOSALS	0.334	0.305	0.304	0.303	0.303	0.301	0.300
	CHANGE IN EFFECTIVE RATE	–0.017	–0.042	–0.041	–0.041	0.040	–0.042	–0.043
70000	ALTERNATIVE TAX PROPOSAL	0.353	0.349	0.348	0.347	0.347	0.345	0.343
	TAX UNDER OUR PROPOSALS	0.367	0.346	0.346	0.345	0.345	0.344	0.343
	CHANGE IN EFFECTIVE RATE	0.014	–0.003	–0.002	–0.002	–0.002	–0.001	0.000
100000	ALTERNATIVE TAX PROPOSAL	0.355	0.351	0.351	0.350	0.350	0.349	0.347
	TAX UNDER OUR PROPOSALS	0.401	0.387	0.386	0.386	0.385	0.385	0.384
	CHANGE IN EFFECTIVE RATE	0.046	0.035	0.035	0.036	0.036	0.036	0.037
200000	ALTERNATIVE TAX PROPOSAL	0.358	0.355	0.354	0.354	0.354	0.354	0.353
	TAX UNDER OUR PROPOSALS	0.450	0.443	0.443	0.443	0.443	0.442	0.442
	CHANGE IN EFFECTIVE RATE	0.092	0.088	0.088	0.089	0.089	0.089	0.089
350000	ALTERNATIVE TAX PROPOSAL	0.362	0.358	0.358	0.358	0.358	0.358	0.357
	TAX UNDER OUR PROPOSALS	0.472	0.468	0.467	0.467	0.467	0.467	0.467
	CHANGE IN EFFECTIVE RATE	0.110	0.109	0.109	0.109	0.109	0.109	0.110
600000	ALTERNATIVE TAX PROPOSAL	0.365	0.363	0.363	0.363	0.363	0.362	0.362
	TAX UNDER OUR PROPOSALS	0.483	0.481	0.481	0.481	0.481	0.481	0.481
	CHANGE IN EFFECTIVE RATE	0.118	0.118	0.118	0.118	0.118	0.118	0.118
1000000	ALTERNATIVE TAX PROPOSAL	0.369	0.367	0.367	0.367	0.367	0.367	0.367
	TAX UNDER OUR PROPOSALS	0.490	0.489	0.489	0.489	0.489	0.488	0.488
	CHANGE IN EFFECTIVE RATE	0.121	0.121	0.121	0.121	0.121	0.121	0.121

Note: See assumptions in Appendix M and earlier in this Appendix.

TABLE N, 2–3

EFFECTIVE MARGINAL TAX RATES UNDER OUR PROPOSALS AND UNDER THE MODIFIED PROPOSALS OF THE COMMITTEE OF FOUR (INCLUDING TAXES PAID BY CORPORATIONS) FOR A TAX UNIT WITH INCOME FROM A TYPICAL PRIVATE COMPANY NOT MAKING USE OF SECTION 105 CAPITALIZATIONS

GROSS CORPORATE SOURCE INCOME		STATUS OF TAXPAYER						
		UNATTACHED INDIVIDUAL	MARRIED COUPLE					
			NUMBER OF CHILDREN					
			0	1	2	3	5	8
1500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.147	0.000	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.283	−0.430	−0.430	−0.430	−0.430	−0.430	−0.430
2000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.168	0.091	0.000	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.262	−0.339	−0.430	−0.430	−0.430	−0.430	−0.430
2500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.170	0.130	0.041	0.000	0.000	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.260	−0.300	−0.389	−0.430	−0.430	−0.430	−0.430
3000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.197	0.157	0.160	0.104	0.007	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.233	−0.273	−0.270	−0.326	−0.423	−0.430	−0.430
3500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.200	0.160	0.161	0.164	0.167	0.000	0.000
	CHANGE IN MARGINAL RATE	−0.230	−0.270	−0.269	−0.266	−0.263	−0.430	−0.430
4000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.218	0.178	0.180	0.180	0.180	0.166	0.000
	CHANGE IN MARGINAL RATE	−0.212	−0.252	−0.250	−0.250	−0.250	−0.265	−0.430
5000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.229	0.189	0.190	0.190	0.190	0.190	0.191
	CHANGE IN MARGINAL RATE	−0.201	−0.241	−0.240	−0.240	−0.240	−0.240	−0.240
6500	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.240	0.200	0.200	0.200	0.200	0.200	0.200
	CHANGE IN MARGINAL RATE	−0.190	−0.230	−0.230	−0.230	−0.230	−0.230	−0.230
8000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.258	0.209	0.210	0.210	0.210	0.210	0.210
	CHANGE IN MARGINAL RATE	−0.172	−0.221	−0.220	−0.220	−0.220	−0.220	−0.220
10000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.278	0.219	0.220	0.220	0.220	0.220	0.220
	CHANGE IN MARGINAL RATE	−0.152	−0.211	−0.210	−0.210	−0.210	−0.210	−0.210
12000	ALTERNATIVE TAX PROPOSAL	0.430	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.298	0.238	0.240	0.240	0.240	0.240	0.240
	CHANGE IN MARGINAL RATE	−0.132	−0.192	−0.190	−0.190	−0.190	−0.190	−0.190
15000	ALTERNATIVE TAX PROPOSAL	0.438	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.318	0.267	0.270	0.270	0.270	0.270	0.270
	CHANGE IN MARGINAL RATE	−0.120	−0.163	−0.160	−0.160	−0.160	−0.160	−0.160
20000	ALTERNATIVE TAX PROPOSAL	0.438	0.430	0.430	0.430	0.430	0.430	0.430
	TAX UNDER OUR PROPOSALS	0.347	0.306	0.310	0.310	0.310	0.310	0.310
	CHANGE IN MARGINAL RATE	−0.091	−0.124	−0.120	−0.120	−0.120	−0.120	−0.120
25000	ALTERNATIVE TAX PROPOSAL	0.483	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.368	0.346	0.350	0.350	0.350	0.350	0.350
	CHANGE IN MARGINAL RATE	−0.115	−0.126	−0.122	−0.122	−0.122	−0.122	−0.122
30000	ALTERNATIVE TAX PROPOSAL	0.484	0.472	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.388	0.377	0.380	0.380	0.380	0.380	0.380
	CHANGE IN MARGINAL RATE	−0.096	−0.095	−0.092	−0.092	−0.092	−0.092	−0.092
40000	ALTERNATIVE TAX PROPOSAL	0.484	0.481	0.472	0.472	0.472	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.417	0.416	0.420	0.420	0.420	0.420	0.420
	CHANGE IN MARGINAL RATE	−0.067	−0.065	−0.052	−0.052	−0.052	−0.052	−0.052
50000	ALTERNATIVE TAX PROPOSAL	0.486	0.483	0.483	0.483	0.483	0.472	0.472
	TAX UNDER OUR PROPOSALS	0.438	0.438	0.440	0.440	0.440	0.440	0.440
	CHANGE IN MARGINAL RATE	−0.048	−0.045	−0.043	−0.043	−0.043	−0.032	−0.032
70000	ALTERNATIVE TAX PROPOSAL	0.487	0.485	0.485	0.485	0.485	0.485	0.485
	TAX UNDER OUR PROPOSALS	0.460	0.460	0.460	0.460	0.460	0.460	0.460
	CHANGE IN MARGINAL RATE	−0.027	−0.025	−0.025	−0.025	−0.025	−0.025	−0.025
100000	ALTERNATIVE TAX PROPOSAL	0.489	0.486	0.486	0.486	0.486	0.486	0.486
	TAX UNDER OUR PROPOSALS	0.499	0.499	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.010	0.013	0.014	0.014	0.014	0.014	0.014
200000	ALTERNATIVE TAX PROPOSAL	0.493	0.489	0.489	0.489	0.489	0.489	0.489
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.007	0.011	0.011	0.011	0.011	0.011	0.011
350000	ALTERNATIVE TAX PROPOSAL	0.497	0.494	0.494	0.494	0.494	0.494	0.496
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	0.003	0.006	0.006	0.006	0.006	0.006	0.004
600000	ALTERNATIVE TAX PROPOSAL	0.501	0.501	0.501	0.501	0.501	0.501	0.501
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.001	−0.001	−0.001	−0.001	−0.001	−0.001	−0.001
1000000	ALTERNATIVE TAX PROPOSAL	0.504	0.504	0.504	0.504	0.504	0.504	0.504
	TAX UNDER OUR PROPOSALS	0.500	0.500	0.500	0.500	0.500	0.500	0.500
	CHANGE IN MARGINAL RATE	−0.004	−0.004	−0.004	−0.004	−0.004	−0.004	−0.004

Note: See assumptions in Appendix M and earlier in this Appendix.

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